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THE SEC/CFTC JURISDICTION AND MARGIN

JOINT HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

AND THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

REGULATORY FRAGMENTATION AND RELATED ISSUES IN THE SECURITIES AND FUTURES MARKETS

MARCH 29, JULY 11, 12, AND 24, 1990

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THE SEC/CFTC JURISDICTION AND MARGIN

THURSDAY, MARCH 29, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 10:00 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (chairman of the subcommittee) presiding.

Present: Senators Dodd, Riegle, Dixon, Sanford, Shelby, Wirth, Heinz, D'Amato, Gramm, Bond, Kassebaum, and Pressler.

Also present, Senator Patrick J. Leahy.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. The subcommittee will come to order.

Let me welcome everyone this morning to our hearing on the regulatory framework and margin requirements for securities and securities-based instruments.

I want to thank our distinguished panel of witnesses for taking the time this morning to help us address some very complex but extremely important issues.

Let me also welcome our dear friend and colleague, Senator Patrick Leahy from Vermont, to what I believe is his first appearance before this subcommittee.

I want to begin by saying that the purpose of this hearing is not to debate the issue of turf which, unfortunately, is how some, both inside and outside of this room, have described these issues. Turf battles make good copy, but they don't necessarily make good policy.

The purpose of this hearing is to talk about capital formation and investor protection and the ways to improve the strength and integrity of the capital-raising process in this country.

We will talk about our international competitiveness—how to keep our financial markets the strongest and most innovative markets in the world.

We will examine law enforcement in our capital markets and the fair treatment of investors and seek the best structure to detect and prosecute those who abuse the system.

At this hearing we also will examine the fundamental question of leverage in our financial markets. To what extent does it generate liquidity and increase the depth and breadth of our markets and therefore facilitate the underlying capital formation function of our markets; and to what extent does it lead to excessive speculation and volatility?

We hope to re-examine our regulatory structure in an objective, dispassionate way. Specifically, we need to determine the practical effect of regulatory fragmentation on the integrity, competitiveness and efficiency of our markets.

At this hearing, like others we have had in the Securities Subcommittee and in the full Banking Committee, we will ask what I believe is the fundamental policy question of financial regulation: How do we permit the risk-taking and innovation that is the essence of capitalism, yet preserve the soundness and integrity of our financial system?

Let us not let these important questions get lost in the debate over turf. This committee simply has too many difficult issues before us to engage in that kind of a conflict, and I'm confident that my friend from Vermont would agree.

Let me also say a word about my friends, Wendy Gramm and Richard Breeden, who will testify here shortly. I don't believe the disagreements we see between these two highly dedicated public servants are at all about turf. It is my view—and I know this not only from their public statements but also from the very frank discussions that we've had in my office as well—it is my view that their differences stem from deeply held philosophical beliefs about the markets under their jurisdictions and the goals and purposes that they should serve, as well as their practical experience as regulators over those markets.

I would not expect Richard Breeden to testify in support of a system that he believes undermines the goals of capital markets any more than I would expect Wendy Gramm to endorse a change in the system that she believes has served us very well over the years. The debate they have engaged is about policy, not about turf, and I believe this subcommittee and the Congress should welcome the strongly held views that they bring to this discussion.

With respect to Chairman Greenspan and Under Secretary Glauber and also to Secretary Brady, who made his views known in the March 2 letter to Senator Heinz and myself, they bring to this debate the views of those with responsibility for the strength and stability of our financial system as a whole. And I will listen, as I'm sure my colleagues will, very carefully to what they have to say.

It would have been far easier for the Treasury to simply endorse the status quo, just as it would be easy for Congress to do the same. But at some point, and I believe we are arriving at that point, this committee and the Congress will have to reach a decision on these crucial questions.

Having said that, I have a great many questions to put to our witnesses this morning. I look forward to hearing a very useful and very worthwhile debate.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, first, I join you in welcoming our distinguished witnesses to the subcommittee today as our subcommittee examines the intermarket regulation of our financial markets. The importance of effective intermarket regulation has been uniformly understood, particularly since the Presidential Task Force on Market Mechanisms, known as the Brady Commission, recognized that our Nation's stock, options and futures markets are in fact one market.

These markets have many of the same participants who use many of the same strategies to trade products that from an economic point of view are essentially the same.

We are indeed fortunate to have all four of the principal Federal agencies responsible for the oversight and regulation of our financial markets being present on our panel today. For the past 2 years they have become known as the Working Group.

In the wake of the October 1987 market crash, the Working Group attempted to address and resolve intermarket regulatory issues. Because the Working Group is the only mechanism in place to ensure effective intermarket regulation, one of the issues that we must assess is how well the Working Group is working.

When the SEC and the CFTC can't agree on whether new innovative hybrid products, such as index participations, are securities or futures and have to resolve their dispute in court, I have to wonder how well the Working Group is working.

When the president of the Federal Reserve Bank of New York states that he's not certain that margins on financial futures are high enough to protect the safety and integrity of the nation's clearance and settlement system, I have to wonder how well the Working Group is working.

When the Secretary of the Treasury expresses concerns that leverage in the futures markets creates the potential for extreme volatility to start in those markets and wash back to the securities markets, I have to wonder how well the Working Group is working.

I am concerned—and here I join you, Mr. Chairman, in particular—that some view intermarket regulatory issues simply as a turf war. It shouldn't be. But if bullets fly between Wall Street and LaSalle Street, the casualties are going to lie on Main Street. And if a battle breaks out between the SEC and the CFTC, it's the safety and competitiveness of our financial markets that will be the victim.

Mr. Chairman, if there has to be a fight, I suggest that the agencies fight on the same side; namely, for effective intermarket regulation. When it comes to maintaining the strongest markets in the world, we can't surrender. We all want the best markets and the best system of regulation and if we work together to find the best way to accomplish that goal everyone will win.

Mr. Chairman, I know Senator Leahy will be speaking at some point. I have a letter from Senator Gorton which he would like me to place in the record and excerpt in part because he was going to appear here to testify, and I will do that at the appropriate point.

Senator DODD. I have been aware of that as well. He has been in touch with me, and he was unable to be here to express his views.

Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Thank you, Mr. Chairman.

At the outset, I want to thank you for inviting me to attend this hearing because as my colleagues know I am not a member of the Securities Subcommittee, but I do have a deep, abiding interest in this morning's subject.

I want to take this opportunity to restate something that I have said many times before and that is that this Senator wants to see a comprehensive set of hearings on the changes in our financial markets. I hope that this hearing can be the start of something that we've needed to do since the crash but which, for a variety of reasons, simply hasn't been done.

We talk a lot at the moment about the revolutionary changes that continue to occur in Eastern Europe and the Soviet Union, but we have not paid similar attention to the even more revolutionary changes in our financial markets. Computerization, massive changes in communication technology, deregulation, institutionalization, and innovation have combined to create a new financial market structure. I don't think we understand yet what those changes mean, but I think that the importance of the issues involved demands that we act cautiously. Our legislative and statutory structure may well be inadequate to cope with these changes, but we haven't yet done the work that's necessary to ensure that we can be confident that any major changes we might recommend will not hurt our markets and will actually any real problems we uncover.

It is imperative I think to do our homework before we act and that is a course I would like to see this committee take.

Having said what I am for, Mr. Chairman, let me also say what I am against. I am against taking actions based on turf wars, empire-building, protectionism, anecdotal evidence or false facts. An article in the October 19, 1988 Wall Street Journal stated:

> The truth is, that since 1980, the financial revolution in trading portfolios rather than individual stocks has caused the Chicago exchanges to prosper relative to the New York Stock Exchange. The big board, although very efficient in making markets in individual stocks, has lagged behind the Chicago exchanges in accommodating the tremendous demand for portfolio trading. Rather than innovate, the New York Stock Exchange has been guilty of trying to use its considerable political leverage to hamstring the Chicago exchanges.

Let no one misunderstand. I will vigorously oppose any proposed action that's based on any of these factors. I want to avoid this kind of battle. I much prefer to work things out. This committee has taken action to strengthen the clearing process and improve large trader reporting systems, among other things. There may well be other short-term improvements we can make while we are conducting a more detailed analysis of our changed markets. I am willing and eager to work with my colleagues and our distinguished witnesses on any of those kinds of suggestions.

Like everyone here, I want to see our markets work well. I want our markets to be fair to all participants and, just as importantly, to be seen to be fair to all participants. I want to ensure that businesses can raise equity in our stock market, something that has been much more difficult since the crash. I simply don't want to take actions that, although well-intentioned, will in fact not accomplish those ends and which carry with them a real danger of harm to our financial markets and our world financial leadership.

May I say in conclusion, Mr. Chairman, that I did not know what the distinguished Chairman of the Fed, Mr. Greenspan, would say this morning. I have read his statement this morning and am pleased to say to you that I think this acknowledged market expert, who is acting without any vested interest on either side of this argument, has made a very balanced and fair statement here that ought to be informative to this subcommittee and to the committee and to the Congress.

I thank the Chair.

Senator Dodd. I would just say to my good friend and colleague from Illinois, we've had a number of hearings on the market issues in just the 101st Congress alone. We've had two hearings on globalization of markets, hearings on the institutionalization 1 market, several hearings on market reform. I have also had numerous hearings on enforcement issues as well as small investor issues. So there's been a tremendous amount of activity both at the subcommittee and in the last Congress at the full committee level on analyzing the effects of the crash. We are going to continue that process.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'Amato. Mr. Chairman, I'd like to commend you and also Senator Heinz for your courage in delving into a highly contentious issue, and it certainly is. The degree to which we need coordination between the equity markets and the markets for equity derivative products is closely related to an issue which was raised in the markup of the Market Reform legislation last fall and that is manipulation of stock prices by the use of index arbitrage in the different markets remains a matter of great concern.

Our efforts to determine whether it's a serious problem and whether the regulators have the tools to protect the investors against such manipulation has given us no satisfactory conclusion to date. Hopefully, this hearing and others will shed some light of what can, what should, what must be done; and not in an attempt to give an advantage to one over the other, but rather to strengthen that market so that it can perform the capital functions which are so great and yet give the necessary protections that I think we all seek.

So, Mr. Chairman, I commend you for the hearing and I think if we approach it on the basis of how do we best protect the capital system and the American investor, hopefully we will come to the kind of conclusion that does not do damage to a great system.

Senator Dodd. Thank you.

We're joined by the full committee chairman, Senator Riegle. Senator Riegle, thank you for coming by.

OPENING STATEMENT OF SENATOR RIEGLE

Senator Riegle. Senator Dodd, I commend you for your strong leadership on this subcommittee and your efforts to move the subcommittee ahead on a variety of very important policy questions and legislative items.

The primary issue to be discussed this morning is whether there is a need to alter the existing regulatory structure of the securities and futures markets.

Like other financial modernization issues, this one should be examined in light of certain basic principles and goals. One such principle is that Congress should act when necessary to ensure that our financial system remains internationally competitive. A related principle is that, where possible, our financial regulatory structure should also be simplified.

After the October 1987 market crash, the Brady task force concluded, "one agency should coordinate the few but critical regulatory issues which have an impact across the related market segments and throughout the financial system."

As Treasury Secretary, Mr. Brady has continued to urge that regulatory jurisdiction be re-allocated between the SEC and the CFTC and has listed a number of options to achieve this result. These options include (1) shifting stock index futures to the SEC; (2) shifting jurisdiction over all financial futures to the SEC and leaving all tangible commodities futures with the CFTC; and (3) merging the SEC and the CFTC.

We are going to be examining the administration's position on this issue this morning with Under Secretrary Glauber and with the other witnesses. I, for one, am looking forward to Mr. Glauber's testimony which I hope will clearly indicate which alternative the Treasury and the administration favor. In fact, I would expect all the witnesses this morning to state their preferred regulatory structure.

I want to commend you again, Senator Dodd, for holding a hearing on such a timely and important issue. I think it's wise to consider the issue of regulatory jurisdiction only after the regulators and the administration have testified regarding their views on this issue. The Working Group of the President, which consists of the panelists that we have with us this morning, was established during the Reagan administration to address just such issues as the one the subcommittee will be discussing today. As always, we have a particularly distinguished group of witnesses in this hearing this morning and I look forward to their testimony.

Let me also say that it's nice to welcome our colleague, Senator Leahy, Chairman of the Agriculture Committee, before us. He is a distinguished member and I am very interested in his testimony as well.

Senator **Dodd**. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator **Gramm**. Mr. Chairman, today we refocus on a debate that is ancient, a debate that predates the SEC and the CFTC and the instruments they regulate. It is a debate between the logic of the concentration of power, which promotes efficiency in Government, and the separation of powers, which promotes freedom and innovation and economic growth.

Here we are talking about unifying regulation to promote the efficiency of regulation on the one hand versus the separation of regulation, which has contributed to innovation, to creation of new products, and to the domination of the world market by those new products.

Mr. Chairman, I am not aware that anyone has argued—and I have talked to the two proponents here today of increased concentration of regulation—but I am unaware that anyone has argued that if this concentration of regulation had existed at the time that there were proposals for the development of new instruments in the futures market which has led to tremendous growth in our futures markets, that futures market growth would have occurred.

We are here today, Mr. Chairman, debating the regulation of products that would not exist today had there been unified regulation, because those product would not have been allowed to come into existence. And if any of our members of the panel disagree with that, I'd like to hear that today in their testimony.

The genius of the American system is to put a bias toward innovation and freedom and the development of private markets as compared to efficiency of Government. I think that genius is reflected in our regulatory structure.

Finally, Mr. Chairman, we cannot fail to be aware of the fact that we have lost our preeminence in that area that is regulated by the SEC. Tokyo, not New York, is now the largest stock market in the world. We are seeing growth in London in the equities markets. And yet the United States of America totally dominates the futures markets, which are the markets that are growing in the world economy. And I believe that in making decisions and in the debate over this important matter, we have to realize that we are not debating here how the financial markets of the world are going to be regulated. We are debating how the United States of America is going to regulate those markets. If we do a poor job, if we impose the heavy, clumsy, dead hand of Government on new and innovative markets, we won't kill those markets; we will simply see those markets spring up elsewhere around the world. In the process the jobs, growth, opportunity, and the genius of freedom that they bring, will be present in other countries and less common in our country.

So, Mr. Chairman, the regulatory strength of two Government agencies is relatively unimportant to me, but the future of the financial markets of America is vitally important to me. I have very strong feelings about it.

Senator DODD. I would have been surprised if I had heard otherwise. After all, you've got to go home at night. [Laughter.]

We're joined by our very good friend, the Chairman of the Senate Agriculture Committee, who is a dear friend and colleague from Vermont and obviously as the jurisdictional question arises here and he expressed an interest in being before us this morning and we truly welcome your participation, Pat, and we're anxious to hear your comments and remarks.

STATEMENT OF PATRICK J. LEAHY, U.S. SENATOR FROM THE STATE OF VERMONT

Senator LEAHY. Thank you very much, Mr. Chairman and Chairman Riegle and Senator Gramm. I will try to bring a live hand of the legislative branch to the hearing and I do appreciate the opportunity to be here.

Last year, Congress faced a crisis in the integrity of trading practices of our nation's commodity futures markets. An FBI "string" on the Chicago exchanges netted indictments of 48 floor traders for cheating customers.

In May, the CFTC subpoenaed records from up to 40 traders on the New York City futures exchanges, also reportedly for floor trading abuses.

In July, we had an emergency and in fact a possible corner of the Chicago soybean market and that raised a storm of protest among farm producers. In November, our former colleague, Senator Tom Eagleton, quit his public director seat at the Chicago Mercantile Exchange and Tom did this to protest insider domination of exchange affairs.

Now last November, the Senate Agriculture Committee, after an extensive inquiry into these events, reported the toughest futures reform package in decades, the Futures Trading Practices Act of 1989, S. 1729.

But, unfortunately, the much needed medicine for the CFTC and the futures industry embodied in that bill is being stalled, tangled up in a struggle between the SEC and the CFTC over who is going to regulate stock index futures contracts.

Mr. Chairman, this jurisdictional debate that has been waged in the press the past few weeks, in my estimation, reflects the 1980's tone of Wall Street. The CFTC has been put in play. It's been made the main course at a "predators ball."

Before this bandwagon gets too far, I must raise alarms about what has emerged as its key proposal. Mr. Chairman, I have overseen futures trading from the Agriculture Committee for almost 16 years. I am convinced that simply shifting jurisdiction for stock index futures from the CFTC to the SEC is not going to strengthen regulation, is not going to end volatility in the stock market, and it is not going to restore investor confidence in Wall Street.

I'll tell you what shifting jurisdiction will do. It's going to cause years of legal uncertainty, waves of bureaucratic squabbling, and weaker—I emphasize—weaker regulation both of stock index and all other futures markets.

At its heart, this proposal raises just what the newspapers have called it—a "turf war" among agencies which have failed to solve their disagreements over margin levels and the introduction of certain new products. Now these issues could have been settled; compromise proposals were floated. Instead, one side has launched a hostile takeover of the other side.

Mr. Chairman, you understand as well as anybody in the Congress, that transferring jurisdiction isn't just a simple affair. You can't just wave a wand, snap your fingers or do whatever you want and jurisdiction is done.

Let's assume that Congress votes to give the SEC power over stock index futures tomorrow. What would they do with it? The SEC currently does not have a program or a staff in place to police futures trading day to day.

Now overseeing the futures pits involves more than just planting a flag and bringing an occasional enforcement case. Simply applying SEC stock or option trading rules en bloc to futures just wouldn't work. I don't know anybody who thinks it would.

To do the job, the SEC would have to recreate a new mini-CFTC under its own roof to supervise the five trading pits in three cities where 14 million stock index futures contracts change hands every year. It would have to conduct compliance audits of four futures exchanges, monitor registrations of tens of thousands of professionals—including retail salespeople coast to coast—and dozens of commodity pools, bring disciplinary cases, provide a "reparations" forum for futures customers, and conduct "economic purpose" reviews of new trading products, unless these last two commodities law protections are dropped in the transfer.

To handle this workload, the SEC would have two choices—either hire away staff experts from the CFTC or staff the SEC futures branch with relative newcomers to audit very, very complex markets.

If the SEC regulates these products as securities, then stock indices would be exempted from the tough trade practice reforms which S. 1729 imposes on other futures markets. There would be no punitive civil damages for customers, no required State-of-the-art audit trails, and no enhanced liability against brokerage firms for floor trading crimes.

And who loses? Well, Mr. Chairman, the biggest losers would be customers in the stock index markets. And the biggest winners would be the lawyers hired to sort out this mess over the next decade.

And where would this leave the CFTC? No one would mistake Congress' message. The CFTC would carry an obvious political black eye. Its best staff members would leave. Its credibility would be crippled, along with its ability to stand up to powerful exchanges trading agriculture, energy, precious metals, and a host of other items. In SEC Commissioner Mary Schapiro's words, the CFTC would be "demoralized and weakened."

This very danger led Secretary Brady's own Market Mechanisms Commission specifically to reject the jurisdiction transfer idea in its highly respected 1988 report.

Now, regulatory coordination is not perfect, but it can work. If margins on stock index futures are too low, or if innovative new products have been blocked, then let's work with the regulators to solve these problems. Every one of those problems are solvable. The past chairmen of the SEC and the CFTC have worked together to resolve conflicts.

If the current incumbents cannot settle their arguments, that is no reason for Congress to conduct radical surgery on a regulatory structure that's evolved over 60 years. Instead, I might suggest that the President should take his appointees to the woodshed and remind them that they are all on the same team. The spectacle of a hostile takeover among regulatory chairmen sheds no glory on the administration. It should not happen.

The Agriculture Committee is ready to work with the Securities Subcommittee to develop solutions to resolve this impasse.

For now, Mr. Chairman, I think we ought to do our job. We ought to pass the tough reform measures reported by our two committees. That's really what should be done because while this turf

battle is going on very tough reform measures are stalled and I would hate to see this Congress end with them still in limbo and the headlines still reading about turf battles.

Thank you very much, Mr. Chairman.

[The complete prepared statement of Senator Leahy follows:]

STATEMENT OF SENATOR PATRICK LEAHY (D-VT)
CHAIRMAN, SENATE AGRICULTURE COMMITTEE
BEFORE THE SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
March 29, 1990

Last year, Congress faced a crisis surrounding the integrity of trading practices at our nation's commodity futures markets. An FBI "sting" on the Chicago exchanges netted indictments of 48 floor traders for cheating customers.

In May, the CFTC subpoenaed records from up to 40 traders on the New York City futures exchanges, also reportedly for floor trading abuses.

In July, an emergency and possible corner of the Chicago soybean market raised a storm of protest among farm producers. In November, Senator Tom Eagleton quit his public director seat at the Chicago Mercantile Exchange to protest insider domination of exchange affairs.

Last November, the Senate Agriculture Committee, after an extensive inquiry into these events, reported the toughest futures reform package in decades. That bill, the Futures Trading Practices Act of 1989 (S.1729), has four main objectives:

1. it beefs up the CFTC, expanding its resources and legal powers, and imposes industry service fees;

2. it requires exchanges to deploy tamper-proof, computerized audit trails within three years and curbs dual trading;

3. it increases penalties against traders who break the rules and allows victimized customers to sue for punitive civil damages from floor traders and brokerage wire houses; and

4. it tightens rules against exchange conflicts of interest.

The futures exchanges and brokerage firms opposed many of these ideas, but the public interest demanded reform. We faced an emergency. Strong medicine was needed.

Unfortunately, the much-needed medicine for the CFTC and futures industry, embodied in our bill, is being stalled, tangled up in a struggle between the SEC and the CFTC over who will regulate stock-index futures contracts.

Mr. Chairman, the jurisdictional debate waged in the press over the past few weeks reflects the tone of 1980s Wall Street. The CFTC has been put "in play," made the main course at a "predators ball."

Before this band-wagon gets too far, I must raise alarms about what has emerged as its key proposal. Mr. Chairman, I have overseen futures trading from the Agriculture Committee for over twelve years. I am convinced that simply shifting jurisdiction for stock-index futures from the CFTC to the SEC will not strengthen regulation, end volatility in the stock market, or restore investor confidence in Wall Street.

Rather, shifting jurisdiction will cause years of legal uncertainly, waves of bureaucratic squabbling, and WEAKER regulation both of stock-index and all other futures markets.

At its heart, this debate is just what the newspapers have called it -- a "turf war" among two agencies that have failed to solve their disagreement over margin levels and the introduction of certain new products. These issues could have been settled; compromise proposals were floated. Instead, one side has launched a hostile takeover of the other.

Unfortunately, as with Wall Street, the fall-out from a bloody takeover war affects not just the warriors; it can harm consumers and markets across the country.

Transferring jurisdiction is not a simple affair. It cannot be done by just waving a wand.

Let's assume that Congress votes to give the SEC power over stock-index futures tomorrow. What would they do with it? The SEC currently has no program, no experience, and no staff in place to police futures trading day-to-day.

Overseeing futures pits involves more than just planting a flag and bringing an occasional enforcement case. Simply applying SEC stock or option-trading rules en bloc to futures would not work.

To do the job, the SEC would have to recreate a new mini-CFTC under its own roof to supervise the five trading pits in three cities where 14 million stock-index futures contracts change hands each year. It would have to conduct compliance audits of four futures exchanges, monitor registrations of tens of thousands of professionals - including retail salesmen coast-to-coast - and dozens of commodity pools, bring disciplinary cases, provide a "reparations" forum for futures customers, and conduct "economic purpose" reviews of new trading products - unless these last two commodities law protections are dropped in the transfer.

To handle this workload, the SEC would have two choices -either gut the CFTC by luring away CFTC staff experts, or staff the SEC futures branch with beginners.

If the SEC regulates stock-index futures as securities, then these products would be exempted from the tough trade practice reforms which S.1729 imposes on other futures markets. There would be no punitive civil damages for customers, no required state-of-the-art audit trails, and no enhanced liability against brokerage firms for floor trading crimes.

The biggest losers would be customers in the stock-index markets. The biggest winners would be the lawyers hired to sort out this mess over the next decade.

And where would this leave the CFTC? No one would mistake Congress' message. The CFTC would carry an obvious political black eye. Its best staff members would leave; its credibility would be crippled, along with its ability to stand up to powerful exchanges trading agriculture, energy, precious metals, and a host of other items. In SEC Commissioner Mary Schapiro's words, the CFTC would be "demoralized and weakened."

This very danger led Secretary Brady's own Market Mechanisms Commission specifically to reject the jurisdiction-transfer idea in its highly-respected 1988 report.

Mr. Chairman: If the CFTC has been too weak a regulator in the past, there are two solutions: First, we can strengthen the CFTC, make it a tougher agency with the tools and backing to crack down on abuses. This is the approach of S.1729, which I favor.

Second, we can combine the CFTC and the SEC into a new super-agency. This job would be complex, requiring us to accommodate many interests, including agricultural producers who would rightly insist in a voice on any new governing Commission.

But realistically, the merger solution is far off. We could not rush it though in what remains of this year's session.

Regulatory coordination is not perfect, but it can work. If margins on stock-index futures are too low, or if innovative new products have been blocked, then let's work with the regulators to solve these problems. We all agree that America must remain pre-eminent in financial innovation and that small investors must not be scared away from the stock market by excessive volatility. Past chairmen of the SEC and the CFTC have worked together to resolve conflicts. The 1982 accord between chairmen John Shad and Philip Johnson and the 1988 negotiations of the Working Group on Financial Markets are good examples.

If the current incumbents, Richard Breeden and Wendy Gramm, cannot settle their arguments, that is no reason for Congress to conduct radical surgery on a regulatory structure evolved over 60 years. Instead, President Bush should take his two appointees to the woodshed and remind them that they are on the same team. The spectacle of a hostile takeover among regulatory chairmen sheds no glory on his Administration.

The trading abuse scandals of 1989 demand prompt enactment of S.1729's tough futures trading reforms, just as the recent collapse of Drexel, Burnham, Lambert demands the prompt enactment of your Stock Market Reform Act, S.648. Public confidence in both Wall Street and LaSalle Street is near all time lows.

The Agriculture Committee is ready to work with the Securities Subcommittee to develop solutions to resolve this impasse, and even to join you in a longer-term study of whether an SEC/CFTC merger is feasible.

But in studying this issue, I ask you to keep in mind that while a transfer of stock-index futures to the SEC may arguably benefit some groups and individuals, there are others to whom it could cause serious harm: farmers, users and producers of goods like heating oil, gasoline, and metals, and those who depend on financial trading in currencies, bonds, and other instruments.

For now, let's do our jobs and pass the tough reform measures reported by our two Committees.

Senator **Dodd**. Thank you very much, Senator Leahy.

I would point out that the reason for our hearing today is to examine the question. This committee has not taken a position on the matter yet before us. I hope as we work our way through it we would examine the questions that the issue of jurisdiction raises because it is obviously far more important than just a jurisdictional battle.

We can't stall all these questions while we wait for an answer on one it seems to me. We've got to move forward. We've got a lot of these issues to raise.

So the purpose here today, will be to examine these issues thoroughly, and this chair has not taken a position yet on the question of jurisdiction.

I would hope that our colleagues would as well listen to the debate and discussion before arriving at any definitive conclusion as to what is in the best interest of the capital markets in this country. As Senator Gramm has said, that really is the issue and that's what we need to be examining. That's why we are here.

I would like to have the same degree of confidence you do in negotiations. If in fact negotiations had worked, if Shad-Johnson had settled things, we wouldn't be here. If in fact the Brady Working Group had been able to reach a consensus on margins, we wouldn't have to have this kind of a hearing.

The fact is that the negotiations haven't always produced results and so it becomes necessary to move the process along. Frankly, I'm not sure we would have gotten an answer to these questions had Senator Heinz and I not persisted in the letters asking for at least some direction from the administration.

Yet everyone knew you couldn't go to a cocktail party in this town and not have someone corner you about how they felt about it. The question was, could we get some public statements coming forward on some of these questions.

So I thank you for your views on this.

Senator **Leahy**. I don't get invited to any cocktail parties, but I'll take your word for it. [Laughter.]

Senator **Dodd**. I think I've seen you at a few.

Senator **Leahy**. I'm Irish you know.

Senator **Dodd**. Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman.

I want to say that I am delighted and I commend you for having this hearing. Regardless of where those social occasions may be in which you hear this position raised and these questions asked, let me assure that they are being asked and I, above all, devoutly hope this does not become a turf battle. I happen to have the unique privilege of serving on both the Banking and the Agriculture Committees and I hope that we can assess the testimony given by the experts today and other information to develop and assure that we have a sound regulatory scheme and that we serve the needs by effective regulation in all of the areas covered.

I look forward to gaining wisdom we've already had shared with us by our chairman of the Agriculture Committee and the other witnesses today.

Senator **Dodd**. Thank you very much.

Senator Leahy, thank you.

Senator **Heinz**. Mr. Chairman. Could I prevail upon Senator Leahy for just 1 minute?

Senator **Leahy**. Go ahead.

Senator **Heinz**. Just on your comment regarding the regulators working it out. It may be that for reasons beyond our control they could have and they didn't, but there is one area in terms of product innovation where there is at least one court decision that says we're in a legal straitjacket. Whether you agree or not with the 7th Circuit——

Senator **Leahy**. That's the Philadelphia situation.

Senator **Heinz**. Well, I'm speaking of the index participations. It's not just the Philadelphia situation.

Senator **Leahy**. It's the Philadelphia situation.

Senator **Heinz**. By the same token, the 7th Circuit sits in Chicago, so if you want to play that game——

Senator **Leahy**. You're talking about the Philadelphia situation. I just want to make sure I understand which one you're talking about.

Senator **Heinz**. Well, it was a Chicago decision. What I'm getting at, irrespective of the geographical location, is that since nobody seems to want to retard product innovation, why isn't it in everybody's interest that the creators of new financial products be able to design a product for either market and let the market participants decide rather than getting into some "Catch-22" with the regulators and the courts?

Senator **Leahy**. I'll let the courts and the regulators work that one out, Senator Heinz.

Senator **Heinz**. Thank you.

Senator **Riegle**. Mr. Chairman——

Senator **Leahy**. We never have parochial matters come up in the Agriculture Committee. [Laughter.]

Senator **Riegle**. Senator Leahy, I respect very much your opinion and the fact that, you've been very directly involved in this now for over a decade as chairman of the committee with jurisdiction over the CFTC. I just want to ask you one question.

That question is, whether or not you feel, based on your knowledge—and it's a difficult question, so I preface it by saying that—when you try to establish the proper balance between the margin requirements for futures and margin requirements for purchases on the stock market, are you satisfied that we have the right sort of cross-connect on these margins? Alternatively, do you think this issue is unclear, say, in the mind of the Agriculture Committee or even in your own mind?

Senator **Leahy**. Cross-connect between—say that again.

Senator **Riegle**. The securities and futures markets have different systems for establishing margin levels. They obviously clear over a different time periods. Are you satisfied that structuring the margins in these separate markets differently nevertheless allows cross-connected margins that adjust their impact on each other so that we don't have any problem?

Senator **Leahy**. I think they do have an impact on each other. If you're asking about whether you're dealing with entirely different ways and reasons for setting margins, we do have. In one instance, markets are cleared daily and sometimes even several times a day as compared to others that take several days to clear. So obviously you're dealing with different margins.

But as I stated in a speech on this about 1½ or 2 years ago, margins obviously is an issue that has to be looked at. There is nothing sacrosanct in changing markets to think that the way of setting margins and the level of margins must always remain the same.

Senator Riegle. But this is a very serious question.

Senator Leahy. Going back and forth between the two, yes, we have looked at that and I would prefer responding to that on the record because it would be a fairly detailed one.

Senator Riegle. Well, I'd like the view of the Agriculture Committee on this matter to the extent that you have looked back from the futures market across to the underlying stock market. I would like to know whether or not your committee is satisfied on the way in which that cross-connection now takes place. If you are, I want to hear that. If you are uncertain about it, I'd like to hear that. But I would like to get a view from you.

Senator Leahy. I will respond on my views. I'm not sure that we would have absolute uniformity among the committee on that point.

Senator Riegle. Very good. Thank you.

Senator Dodd. Senator Sanford, do you have any?

Senator Sanford. I've got a good question, but I don't want to hold him up. I wanted to ask if you think that CFTC and SEC ought not to be combined, would you be amenable to giving jurisdiction of CFTC to the Banking Committee? [Laughter.]

Senator Leahy. I would probably breathe a huge sigh of relief, Senator.

Senator Sanford. Let the record so show.

Senator Dodd. Thank you, Senator Leahy.

Senator Heinz. This hearing is adjourned. [Laughter.]

Senator Leahy. But I think you would find an awful lot of people in the agricultural community who would not feel very comfortable if they thought on all these agricultural issues, very important to your state as well as a number of other states, that it was being handled at the SEC and not in the normal futures markets. I don't think they would be comfortable at all. Because of that, I will yield to my own ability to take it easy by protecting their interests. Thank you.

Senator Dodd. Senator Leahy, we thank you for being with us this morning.

Senator Sanford, do you have an opening comment you would care to make?

Senator Sanford. Yes, sir. I would like to put it in the record. Thank you.

Senator Dodd. I thank you for that.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator Sanford. Thank you, Mr. Chairman. I appreciate your efforts in calling for this hearing and I thank our distinguished witnesses for appearing before us this morning. Today we are again examining a very critical, but obviously very controversial and unsettled issue—whether and how to more closely align the regulation of stocks with the regulation of financial futures, as well as the issue of harmonizing margins across the two markets.

As we all know, following the stock market crash of 1987, a great deal of time and energy was spent examining the crash and how and why it occurred. As a result of those efforts, numerous and voluminous reports were issued, perhaps most prominently the Brady Commission report. The Brady Commission essentially made five key recommendations: (1) that one agency should coordinate the few, but critical regulatory issues which have an impact across the related market segments, (2) that the clearing systems should be unified; (3) that margins should be made consistent to control speculation and financial leverage; (4) that circuit breaker mechanisms should be formulated and implemented to protect the market system; and (5) that information systems should be established to monitor transactions and conditions in related markets.

While progress has been made on a number of these issues, two of the central tenents of the Brady Commission report—the call for one agency to coordinate certain key issues and for harmonized margins has largely been left to the Presidential Working Group. I know I share the frustration of many of my colleagues that little agreement has been reached among that Group on some of these issues and that for large periods of time the Group was not even meeting regularly.

As such, I think the time has come for the Congress to consider at these issues. However, in so doing, I think we need to look very critically at the pros and cons of the various approaches Secretary Brady has suggested in his recent letter. We need to understand how each of those proposals would actually be implemented and what gain would come out of any change before we establish a new structure. At the hearing this subcommittee held recently on the state of the securities industry, the question was asked as to what difference it would make and what the SEC would do differently if given jurisdiction over financial futures, and I am not sure we received entirely satisfactory answers. But the problem of coordination between the two markets remains and we need to address that problem now.

I also believe that part of the problem of volatility in the markets and related concerns stems from the fundamental shift we have seen from individual investors to large, institutional holdings. As was pointed out during a hearing we held last fall with such institutional investors, many of these funds have very rapid turnover rates, which helps fuel the volatility and shortens the time horizons of many managers.

In looking at this problem of churning, a number of us have considered various options. In introducing a bill related to corporate takeovers and leveraged buyouts, my colleague Jim Sasser and I included a proposal to apply the so-called "short-short" rule that currently applies to mutual funds to pension funds as well. Such a rule would prohibit funds from making more than 30 percent of their income from shares held for less than 3 months. Our colleagues from Kansas have suggested an alternative notion of taxing the gains from very short-term trading. In think both approaches deserve further study and consideration as we look at ways to address problems of excessive volatility and a very short-term focus in the market.

I think these issues are very important to future of our financial markets and that we must be prepared to examine them carefully and to take the action that is needed. I hope that our witnesses this morning can help us understand just how things would work under any new regulatory structure and what benefits and losses such changes might bring.

I might also add that while the committee was pleased to finally receive Secretary Brady's March 2 letter, I was disappointed that the Treasury was not prepared to give us more concentrate comments on proposals to regulate corporate takeovers and leveraged buyouts. The request made to the Treasury asked for comments on a number of very specific items and legislative proposals. I hope that the Treasury will give us its specific comments soon, as I think this is a matter the committee should address this year. While many may say that the market has taken care of things, I believe that the opportunity for abuse is still there, that deals to restructure the bad deals of the 1980's will start and that we ought to have a better set of rules in place now.

I look forward to hearing testimony on these issues.

Thank you, Mr. Chairman.

Senator **Dodd**. Senator Pressler?

Senator **Pressler**. Mr. Chairman, I have an opening statement which I shall now put in the record, but I will say that I have a letter signed by several farm organizations urging—it has 19 national agricultural organizations—urging Congress maintain an independent CFTC with exclusive jurisdiction over futures contracts. As requested by those organizations, I request that this letter be made a part of the record of this hearing.

Senator **Dodd**. Without objection, so ordered.

STATEMENT BY SENATOR LARRY PRESSLER

Senator **Pressler**. Thank you, Mr. Chairman. The issues that are raised in our hearing this morning are extremely important and especially complex. That they are the issues which have loomed before us ever since the crash of October 1987 indicates the necessity of our finding solutions to the problems that are still out there.

We are fortunate to have witnesses before us today who are eminently qualified to further delineate the problems involved in regulating the securities and futures markets and to propose well-reasoned solutions.

As a farm State legislator, I also appreciate reading the statement submitted to us by our colleage and Chairman of the Senate Agriculture Committee, Patrick Leahy. I share his concerns about the effect on agricultural commodities and their markets of various proposals that have been made for shifting regulation of the commodity futures markets. In that respect, Mr. Chairman, I have received a letter, as I assume you have, in which 19 national agriculture organizations have joined urging Congress to maintain an independent CFTC with exclusive jurisdiction over futures contracts. As requested by those organizations, I request the letter be made a part of the record in this hearing.

March 27, 1990

Dear Senator Pressler:

As representatives of all segments of U.S. agriculture, we are writing to express our deep concern with the jurisdictional dispute between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). In recent weeks, some have asserted that the SEC, not the CFTC, should have jurisdiction over some financial futures contracts, most notably stock index futures. We believe this could ultimately jeopardize agricultural futures.

Why are we as agricultural groups worried about stock index futures? Because the CFTC regulates exchanges, not just contracts. Agricultural and financial futures are traded on the same trading floors, subject to the same rules, by the same people. Dual agency jurisdiction . over futures exchanges, under two different laws, would be a prescription for regulatory chaos.

We support a strong, independent CFTC with exclusive jurisdiction over futures contracts. A strong CFTC would be strengthened even more under the Senate's pending reauthorization legislation.

We vigorously oppose weakening the CFTC by splitting-off some of its jurisdiction. We are equally opposed to the idea of making the CFTC a division of the SEC. Such a combination would be unworkable because the SEC has no experience in agricultural futures or their regulation. The SEC would undoubtedly seek to superimpose its view of stock market regulation on futures markets. Although futures markets have a 140-year tradition of providing efficient price discovery and hedging mechanisms, these are roles and functions that are fundamentally different from the markets the SEC now oversees. For example, a recent NEW YORK TIMES article quotes SEC Commissioner Edward Fleischman as saying, "We really don't understand those markets, it is a different world. You tell me what we would do differently. I would venture to say nothing."

The efficient, fair pricing of agricultural products would inevitably suffer under a change in jurisdictional authority. We should not leave the impression we always agree with the CFTC, but we value the expertise developed under current oversight authority during nearly 70 years of futures market regulation. For these reasons, we strongly urge Congress to maintain an independent CFTC.

Sincerely,

American Cotton Shippers Association
American Farm Bureau Federation
American Oat Association
American Soybean Association
Millers' National Federation
National Association of Wheat Growers
National Cattlemen's Association
National Corn Growers Association
National Cotton Council
National Council of Farmer Cooperatives
National Farmers Organization
National Farmers Union
National Grain and Feed Association
National Grain Sorghum Producers Assoc.
National Grain Trade Council
National Grange
National Pork Producers Council
North American Export Grain Assoc.

Senator **Dodd**. Senator Heinz, I believe you wanted to insert something.

Senator **Heinz**. Mr. Chairman, we had a second witness that was scheduled to appear, Senator Gorton, of Washington. He has sent a letter. I ask unanimous consent that the entire letter be placed in the record.

Senator **Dodd**. Without objection.

[Committee insert of Senator Gorton's letter follows:]

SLADE GORTON
WASHINGTON

730 HART SENATE OFFICE BUILDING
(202) 224-3441

United States Senate
WASHINGTON, DC 20510

COMMITTEES
AGRICULTURE
ARMED SERVICES
COMMERCE, SCIENCE, AND TRANSPORTATION
INDIAN AFFAIRS

March 28, 1990

The Honorable Christopher Dodd
Chairman
Banking Subcommittee on Securities
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chris:

I am pleased that you have scheduled a hearing in the Securities Subcommittee to address the issue of jurisdiction over stock-index futures. Two major disruptions in the late 1980s seriously eroded investor confidence in the financial markets. This loss of confidence, in turn, adversely affects the operation of capital markets and the provision of capital necessary for a growing economy. We must address the causes of those disruptions and provide means by which similar events may be avoided in the future.

As you know, I have introduced an amendment to the Futures Trading Practices Act (S. 1729) that would transfer authority for stock-index futures from the Commodity Futures Trading Commission (CFTC) to the Securities and Exchange Commission (SEC). Although this amendment focuses on just one element of securities regulation, I believe a change in this area could contribute significantly to restoring stability and confidence in the markets.

I am convinced that trading in stocks, options and stock-index futures constitute one interrelated market. Trading in either the derivative markets or the stock market has a direct and material effect on the other. My amendment would unify jurisdiction over these financial instruments and allow for more consistent and effective regulation.

The CFTC and SEC are agencies with distinct agendas and objectives. This fact is detrimental to the financial markets for at least two reasons. First, with separate agencies with differing goals and views regulating closely linked markets, the rules and practices governing those markets are inevitably inconsistent. Coordination of regulatory responses to a market crisis is problematic at best. Unification, on the other hand, will permit a more consistent approach to regulation over abusive intermarket trading practices, such as frontrunning through program trading, and will also ensure a coordinated reaction to market swings.

3206 JACKSON FEDERAL BUILDING
915 SECOND AVENUE
SEATTLE, WA 98174
(206) 442-0350

130 FEDERAL BUILDING
500 WEST 12TH STREET
VANCOUVER, WA 98660
(206) 696-7838

697 U.S. COURT HOUSE
W. 920 RIVERSIDE AVENUE
SPOKANE, WA 99201
(509) 353-2507

Second, two agencies prevent the United States from speaking with a unified voice during international negotiations on financial markets. Other countries with major securities markets have a single body regulating their markets. Thus, they are better able to present clear priorities and negotiating objectives than is the United States. This amendment would move to correct the disadvantage under which we have placed ourselves.

Two members of the Working Group on Financial Markets publicly have expressed support for transfer of jurisdiction of stock-index futures. In addition, they have expanded their focus to include other issues related to regulatory fragmentation, such as jurisdiction over new products and margin levels. I am interested in seeing debate on these issues as well, and subsequent reforms which are necessary to prevent a recurrence of the volatility in the markets that marked the 1980s.

I commend you and Senator Heinz for scheduling a hearing to address the issue of jurisdiction over stock-index futures. We, in Congress, cannot continue to delay implementing reforms that are necessary for restoring and maintaining stability in the markets.

I will continue to pursue this issue as it develops and look forward to your hearing on Thursday.

Sincerely,

Slade Gorton

SG/jer

Senator **Heinz**. He has asked that I simply read the sum and substance of his letter. He is the author of an amendment to S. 1729, which would transfer the authority for stock index futures from the CFTC to the SEC. He's convinced that trading in stocks and options and stock index futures constitute one interrelated market. Trading in either the derivative market or the stock market he says has a direct and material effect on the other. He makes two points about the SEC and the CFTC having agencies with distinct and separate agendas and that that is a detriment to the financial markets for two reasons. First, separate agencies with different goals and views regulating closely linked markets, the rules and practices governing those markets are inevitably inconsistent. He says, second, two agencies prevent the United States from speaking with a unified voice during international negotiations on financial markets.

Mr. Chairman, I don't enter those comments into the record on behalf of myself, just as a favor to Senator Gorton who would otherwise have been a witness.

Senator **Dodd**. Thank you very much and those comments will be included in the record.

We are delighted this morning to have our principal panel of four very distinguished witnesses who graciously made time available to this committee to examine the issues before us.

Senator Shelby, do you have any opening comments?

Senator **Shelby**. Mr. Chairman, I have no opening statement at this time but I am eager to hear our witnesses.

Senator **Dodd**. I have a statement from Senator Sasser for insertion in the record.

STATEMENT OF SENATOR JIM SASSER

Senator **Sasser**. Mr. Chairman, I want to thank you for calling this hearing on this important issue.

Volatility in our securities markets is a problem we all want to address. Both the crash of 1987 and last October's 200-point drop have caused many fingers to be pointed at program trading, and at stock index futures in particular.

But I'm not yet convinced that any one financial instrument is singularly responsible for all of our volatility problems. It's likely that there are many causes. It may very well be that trading in stock futures is a leading cause. However, the roots of volatility may be more general and wide-reaching than that. It may be that we have excessive volatility because much more stock is owned by institutions. And for a variety of reasons, these institutions tend to turn over their ownership faster. The largest pension funds, for example, report turning over, on average, 70 percent of their portfolio assets each year, while turnover rates of up to 1,000 percent a year are not uncommon.

Senator Sanford and I have introduced a bill called the "Long-Term Investment, Competitiveness and Corporate Takeover Reform Act of 1990." The bill contains an anti-churning rule called the "short-short" test. Under the short-short test, mutual funds are required to earn at least 70 percent of their income from stocks held for over 3 months. Our bill would extend this rule to pension funds, the logic being that all the big players should be under the same rules.

With less churning by the big players in the market, the likely result will be [illegible] volatility. This will in turn encourage the return of the small [illegible] [illegible] individuals who are typically long-term owners. And with more long-term owners, our corporate managers can afford to look beyond the narrow concerns of the coming quarter, and make the long-term investments necessary for future growth and competitiveness in the global economy.

There's no doubt that excessive volatility has been an impediment to long-term investment and effective cash management strategies of both individuals and corporations. My concern is that we fully examine the structural causes of our volatility, and not look to stock futures as a scapegoat.

Mr. Chairman, I ask unanimous consent that this letter from a group of agricultural interests be admitted as part of the record of this hearing. Thank you.

March 27, 1990

Dear Senator Sasser:

As representatives of all segments of U.S. agriculture, we are writing to express our deep concern with the jurisdictional dispute between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). In recent weeks, some have asserted that the SEC, not the CFTC, should have jurisdiction over some financial futures contracts, most notably stock index futures. We believe this could ultimately jeopardize agricultural futures.

Why are we as agricultural groups worried about stock index futures? Because the CFTC regulates exchanges, not just contracts. Agricultural and financial futures are traded on the same trading floors, subject to the same rules, by the same people. Dual agency jurisdiction over futures exchanges, under two different laws, would be a prescription for regulatory chaos.

We support a strong, independent CFTC with exclusive jurisdiction over futures contracts. A strong CFTC would be strengthened even more under the Senate's pending reauthorization legislation.

We vigorously oppose weakening the CFTC by splitting-off some of its jurisdiction. We are equally opposed to the idea of making the CFTC a division of the SEC. Such a combination would be unworkable because the SEC has no experience in agricultural futures or their regulation. The SEC would undoubtedly seek to superimpose its view of stock market regulation on futures markets. Although futures markets have a 140-year tradition of providing efficient price discovery and hedging mechanisms, these are roles and functions that are fundamentally different from the markets the SEC now oversees. For example, a recent NEW YORK TIMES article quotes SEC Commissioner Edward Fleischman as saying, "We really don't understand those markets, it is a different world. You tell me what we would do differently. I would venture to say nothing."

The efficient, fair pricing of agricultural products would inevitably suffer under a change in jurisdictional authority. We should not leave the impression we always agree with the CFTC, but we value the expertise developed under current oversight authority during nearly 70 years of futures market regulation. For these reasons, we strongly urge Congress to maintain an independent CFTC.

Sincerely,

American Cotton Shippers Association
American Farm Bureau Federation
American Oat Association
American Soybean Association
Millers' National Federation
National Association of Wheat Growers
National Cattlemen's Association
National Corn Growers Association
National Cotton Council

National Council of Farmer Cooperatives
National Farmers Organization
National Farmers Union
National Grain and Feed Association
National Grain Sorghum Producers Assoc.
National Grain Trade Council
National Grange
National Pork Producers Council
North American Export Grain Assoc.

Senator DODD. I would like to invite all four witnesses to join us at the table.

Robert Glauber, Under Secretary for Finance, Department of the Treasury, Alan Greenspan, who has spent numerous hours before this committee over the years, the Chairman of the Board of Governors of the Federal Reserve System, Richard C. Breeden, Chairman of the Securities and Exchange Commission, and last but not at all least, Wendy Gramm, Chairman of the Commodity Futures Trading Commission.

We are honored to have all four of you present before the committee. You have heard already what a mild issue this is in terms of the reactions of some members, but obviously, it is important that we have sentiments expressed by all four of you this morning.

I will begin with you, Mr. Glauber, and proceed in the order in which I have introduced you.

Again, your full statements will be included in the record and any additional materials you may wish.

We will ask you to try and abbreviate to the extent possible—some of the testimony is a little lengthy—so we can get to the questions.

STATEMENT OF ROBERT GLAUBER, UNDER SECRETARY FOR FINANCE, DEPARTMENT OF THE TREASURY

Mr. GLAUBER. Mr. Chairman, then with that in mind, let me excerpt my full testimony.

Senator DODD. That will be appreciated.

Mr. GLAUBER. Chairman Dodd, Senator Heinz, members of the subcommittee. Thank you for this opportunity to discuss the Treasury Department's views on regulatory fragmentation and related issues in the securities and futures markets. We continue to believe that it is important to increase investor confidence and promote innovation in our financial markets. This means taking necessary steps to reduce the chances of major market disruptions, while streamlining and reducing regulation.

As Secretary Brady has said many times, whatever steps we take must include the recognition that securities and derivative markets are really one market. I believe the financial community already recognizes this fact, as do regulators in other countries. The question is whether our regulatory structure needs change in order to recognize this fact as well—whether integrated markets require some form of unified regulation, and whether this will result in additional progress on key intermarket issues.

The Treasury Department believes the answer to this question is yes, both to preserve the preeminence of our markets and to enhance investor confidence. As you know, the President's Working Group on Financial Markets, whose members are all here today, has discussed this issue. This is only appropriate, since the very purpose of the Working Group is to address intermarket issues, and regulatory fragmentation is obviously central to the question of intermarket coordination.

These discussions have proved extremely useful in informing Working Group members of each other's concerns. There is much common ground, and the discussions should continue on this and related intermarket issues in order to promote continued understanding and cooperation. Of course, the Working Group is not and never was intended to be a single agency with a single viewpoint.

Therefore, my testimony today reflects the views of the Treasury Department, just as I am sure the testimony of my colleagues will reflect their views.

Let me begin with a description of one of the fundamental problems that needs to be addressed—the concern that major market disruptions are sapping investor confidence—and discuss certain well-publicized "solutions" that we reject.

I will conclude with specific suggestions for more unified regulation, which will address the key issues of competitiveness and enforcement as well.

The linkage among stocks, stock options, and stock index futures directly affected the market breaks in October 1987 and October 1989. Both days demonstrated dramatically how these markets, all operating on their own set of rules, can interact to create a major financial disruption.

These events, along with other instances of major market disruptions, have contributed to declining investor participation and capital formation in the United States.

If we are to bring investors back into our markets to stay, we need to renew their confidence that market mechanisms are operating efficiently; that markets are fair, not rigged; that they are still safe places to invest; and that regulation is effective.

As mentioned at the outset, there are a number of ways to help achieve these results. But it is imperative that we avoid overreacting in a way that will stifle innovation.

For example, the Treasury Department shares many of the concerns that have been expressed about problems associated with excessive market volatility. But we completely disagree with those who suggest that the solution is to outlaw financial futures or ban program trading.

The financial futures markets are one of our country's most vital and innovative financial resources, as Senator Gramm has suggested. Any attempt to outlaw such futures or to regulate them to the point where they cease to serve an economic purpose would be a grave mistake. Not only is there little evidence that futures contracts have had any negative effect on the economy, but we believe their use has helped keep our cost of capital lower than it otherwise would be. We would like to do nothing to stifle the health of that industry.

Likewise, the Treasury Department has repeatedly opposed the blunt approach of Government intervention to stop program trading. In our view, it is far better to focus on the fundamental mechanisms of the individual markets and the inconsistency of intermarket regulation.

We believe the key intermarket issue is regulatory fragmentation. In the past we have tended to focus too narrowly on discrete intermarket issues. Instead, we need to embrace a unified regulatory framework to promote innovation and competitiveness; to deal with enforcement problems; and to coordinate market mechanisms to avoid major market disruptions.

These goals are extremely important but difficult to accomplish in our currently balkanized system.

The other countries with major securities markets do not fragment their regulation this way. Japan, the United Kingdom and France, which together with the United States account for 90 percent of global futures trading, recognize the "one market" reality—each country assures that regulation of stocks, options, and futures is coordinated by a single regulator. Yet here in the United States, by reason of historical accident, the Securities and Exchange Commission regulates stocks and stock options, while the Commodity Futures Trading Commission regulates stock index futures.

By integrating our fragmented system, we stand to gain significant benefits.

The first is innovation. In the past, fragmented regulation sometimes promoted innovation, as Senator Gramm has suggested. Competition between Chicago and New York markets spurred new product development, while the practices of different regulators often promoted diversity, experimentation and creativity.

But regulatory competition also causes jurisdictional squabbles, which can strangle innovation. New products are not merely stifled; they quickly move to overseas markets. This is demonstrated only too well by the recent court battle over a new "hybrid" product called index participations. Meanwhile, trading of the new product has stopped in the United States. It has begun trading in Toronto, with London soon to follow.

My point is this: with the globalization of financial markets, other countries have provided us all the regulatory competition we need. We can no longer afford intramural squabbling that stifles innovation at home and drives important business overseas.

I want to emphasize that this is not a turf battle and should not be a turf battle between agencies, but it is a problem that is codified in the law.

A second benefit is enforcement. Unified regulation would substantially enhance enforcement efforts to stop intermarket violations. Like state troopers who are forced to stop at the State line when chasing lawbreakers, today the SEC and CFTC are often prevented from dealing effectively with intermarket abuses such as manipulation and front-running. While progress has been made, there is still no universally accepted definition of illegal front-running, and substantial gaps remain in our capacity to detect and deter cross-market abuses.

Finally, Secretary Brady has often cited the problems created by conflicting rules applying to fundamental market mechanisms, including unharmonized margin requirements and uncoordinated circuit breakers. Taken together, they foster excessive volatility, heighten risk and drive investors away from the markets.

For example, low futures margins indirectly permit high leveraging in stocks. This leverage creates the potential for major market disruptions, starting in the futures market and washing back to the stock market. The active use of this leverage has the potential, when concentrated in short periods of time, to punch a hole in the fabric of the market.

Likewise, uncoordinated circuit breakers and clearance and settlement systems can risk major market disconnections. Coordinating these and other market mechanisms demands a more unified approach.

In short, what we have is a single market with uncoordinated and even conflicting regulations. That may have created benefits in the past when markets were less connected and overseas competition was minimal. But now it creates problems, as I have just described.

The solution is not complicated, though it may be difficult to put in place. We do not need more regulation. But we do need to move towards more unified regulation as the umbrella under which specific intermarket issues can be much more easily resolved. The result will be more streamlined and efficient regulation.

Obviously, the broadest solution would be to merge the SEC and the CFTC. This would make our regulatory system similar to other major financial competitors in foreign countries. Moreover, by unifying all regulation, we could address not only the intermarket issues we now recognize, but new ones that are bound to arise as innovation continues.

A different solution would be to unify regulation of those markets that are particularly connected. This could range from unified regulation of all financial products and their derivatives to unified regulation of stock-related products.

We believe the minimum course of action would be to unify regulation of stocks, stock options and stock index futures under the agency with the greatest overall expertise in the combination of these products—the SEC. Margin authority over each of these products would also require consolidation in a single regulator. In addition, it is imperative that we end the jurisdictional disputes over the regulation of new products that simply drive them to overseas markets. This would require elimination of the so-called "exclusivity" clause in the Commodity Exchange Act, which currently requires exclusive CFTC regulation of any instrument that has any element of "futurity."

This minimum solution would deal comprehensively with the most prominent problems we now face. Moreover, because index futures are only a small percentage of the transactions regulated by the CFTC, it would not be a radical departure from the existing regulatory scheme.

In conclusion, the benefits of unified regulation are substantial. While we embrace this approach, I want to emphasize our belief that today's problems do not come from the regulators themselves. Both the CFTC and the SEC are doing a good job under difficult circumstances—administering a scheme of regulation that simply is not designed for the unified marketplace they are expected to regulate. We believe the answer is a coherent regulatory structure that can deal effectively with unified markets. Resolving regulatory fragmentation will promote investor confidence, which is a key to our long-term competitiveness.

Thank you, Mr. Chairman.

[The complete prepared statement of Robert Glauber follows:]

Statement of
The Honorable Robert R. Glauber
Under Secretary of the Treasury for Finance
Before the
Subcommittee on Securities, U.S. Senate Committee on
Banking, Housing, and Urban Affairs

March 29, 1990

Chairman Dodd, Senator Heinz, and Members of the Subcommittee:

Thank you for this opportunity to discuss the Treasury Department's views on regulatory fragmentation and related issues in the securities and futures markets. We continue to believe that it is important to increase investor confidence and promote innovation in our financial markets. This means taking necessary steps to reduce the chances of major market disruptions, while streamlining and reducing regulation.

As Secretary Brady has said many times, whatever steps we take must include the recognition that securities and derivative markets are really one market. I believe the financial community already recognizes this fact, as do regulators in other countries. The question is whether our regulatory structure needs change in order to recognize this fact as well -- whether integrated markets require some form of unified regulation, and whether this will result in additional progress on key intermarket issues.

The Treasury Department believes the answer to this question is yes, both to preserve the preeminence of our markets and to enhance investor confidence. As you know, the President's Working Group on Financial Markets, whose members are all here today, has discussed this issue. This is only appropriate, since the very purpose of the Working Group is to address intermarket issues, and regulatory fragmentation is obviously central to the question of intermarket coordination.

These discussions have proved extremely useful in informing Working Group members of each other's concerns. There is much common ground, and the discussions should continue on this and related intermarket issues in order to promote continued understanding and cooperation. Of course, the Working Group is not and was never intended to be a single agency with a single viewpoint.

Therefore, my testimony today reflects the views of the Treasury Department, just as I am sure that the testimony of my colleagues will reflect their views.

Let me begin with a description of one of the fundamental problems that needs to be addressed -- the concern that major market disruptions are sapping investor confidence -- and discuss certain well-publicized "solutions" that we reject. I will conclude with specific suggestions for more unified regulation, which will address the key issues of competitiveness and enforcement as well.

Need to Enhance Investor Confidence

The linkage among stocks, stock options, and stock index futures directly affected the market breaks in October 1987 and October 1989. Both days demonstrated dramatically how these markets, all operating by their own sets of rules, can interact to create a major financial disruption.

These events, along with other instances of major market disruptions, appear to have contributed to declining investor participation and capital formation in the United States:

- Initial Public Offerings (IPOs) have plummeted since the 1987 market break. After peaking at $18 billion in 1986, IPOs raised only about $6 billion a year in 1988 and 1989.
- Equity offerings as a percentage of new funds raised domestically has fallen off dramatically. In the early 1980s, equity accounted for about 30-50 percent of all public new issues, but the share dwindled to only 10 percent in 1989.
- The percentage of stock outstanding held by individuals has declined from 84 percent in 1965 to 55 percent in 1989.

- Trading volume in options, futures, and stocks is off substantially from levels that prevailed before the October 1987 market break.

If we are to bring investors back into our markets to stay, we must renew their confidence that market mechanisms are operating efficiently; that markets are fair, not rigged; that they are still a safe place to invest; and that regulation is effective.

Need to Avoid Overreaction

As mentioned at the outset, there are a number of ways to help achieve these results. But it is imperative to avoid overreaction that will stifle innovation.

For example, the Treasury Department shares many of the concerns that have been expressed about problems associated with excessive market volatility. But we completely disagree with those who suggest that the solution is to outlaw financial futures or ban program trading.

The financial futures markets are one of our country's most vital and innovative financial resources. Any attempt to outlaw such futures or to regulate them to a point where they cease to serve an economic purpose would be a grave mistake. Not only is there little evidence that futures contracts have had any negative effect on the economy, but we believe their use has helped keep our cost of capital lower than it otherwise would be.

Instead of attempting to limit the use of futures, we need to find better ways to integrate them into the "one market" so that they do not destabilize the system. A more integrated regulatory framework, I believe, will help avoid major disruptions and help make our financial system more stable, efficient, and competitive.

Likewise, the Treasury Department has repeatedly stated its view that the blunt approach of government intervention to stop program trading is an inappropriate way to address problems of excessive market volatility. Rather than trying to restrict particular trading strategies, it would be far better to focus on the fundamental mechanisms of the individual markets and the inconsistency of intermarket regulation that can themselves engender unnecessary volatility.

Provisions to restrict program trading, like the one recently approved by the House Energy and Commerce Committee, represent a fragmented approach that itself could be disruptive. Because this type of provision would apply only in the stock market, it could promote ad hoc responses to market turmoil that would create additional uncertainty, which in turn could actually destabilize markets because of the lack of coordination.

Indeed, the uncertain application of restrictions on trading strategies could simply drive market participants to foreign markets to execute the stock side of program trades. This would directly reduce the competitiveness of United States markets. Accordingly, we continue to strongly oppose program trading restrictions as overly broad and potentially harmful. Instead, we believe that Senator D'Amato's amendment to the Market Reform bill -- which would require the SEC to report on the adequacy of its current authority to protect against market manipulation or fraud caused by program trading -- is a more constructive approach.

The Need to Address Regulatory Fragmentation

While banning futures or program trading is not the right approach to addressing intermarket problems, other steps can and should be taken. One is the enactment of S.648, "The Market Reform Act of 1989," which is clearly a step in the right direction. The recent collapse of Drexel Burnham Lambert Group only underscores the need for two of the bill's provisions -- holding company risk reporting and measures to improve the clearance and settlement system. Similarly, the market breaks of October 1987 and October 1989 demonstrated the need for timely reporting of large trader transactions. We continue to urge prompt action on this legislation.

Nevertheless, as important as this legislation is, it does not address the key intermarket issue, which is regulatory fragmentation. In the past we have tended to focus too narrowly on discrete intermarket issues. Instead, we need to embrace a unified regulatory framework to promote innovation and competitiveness; to deal with enforcement problems; and to coordinate market mechanisms to avoid major market disruptions. These goals are extremely important but difficult to accomplish in our currently balkanized system.

We believe that progress on all these issues requires some form of unified regulation. Since securities and their derivatives really comprise one market, this only makes sense. How can we really expect to make substantial progress if our right hand does not always know what our left is doing, and can do very little about it even when it does?

The other countries with major securities markets do not fragment their regulation this way. Japan, the United Kingdom, and France, which together with the United States account for 90 percent of global futures trading, recognize the "one market" reality -- each country assures that regulation of stocks, options, and futures is coordinated by a single regulator. Yet here in the United States, by reason of historical accident, the Securities and Exchange Commission regulates stocks and stock options, while the Commodity Futures Trading Commission regulates stock index futures.

By integrating our fragmented system, we stand to gain significant benefits in innovation, enforcement, coordinated market mechanisms, and globalization.

Innovation. In the past, fragmented regulation sometimes promoted innovation. Competition between Chicago and New York markets spurred new product development, while the practices of different regulators often promoted diversity, experimentation, and creativity.

But regulatory competition also begets jurisdictional squabbles, which can strangle innovation. New products are not merely stifled; they quickly move to overseas markets. This is demonstrated only too well by the recent skirmish over a new "hybrid" product called index participations. The battle over whether it is a stock or a futures product continues to rage in our courts. Meanwhile, trading of the new product has stopped in the United States and begun in Toronto, with London soon to follow.

My point is this: with the globalization of financial markets, other countries have provided us all the regulatory competition we need. We can no longer afford intramural squabbling that stifles innovation at home and drives important business overseas.

Enforcement. Unified regulation would substantially enhance enforcement efforts to stop intermarket violations. Like state troopers who are forced to stop at the state line when chasing lawbreakers, today the SEC and CFTC are often prevented from dealing effectively with intermarket abuses such as manipulation and frontrunning. While progress has been made, there is still no universally accepted definition of illegal frontrunning, and substantial gaps remain in our capacity to detect and deter cross-market abuses.

In short, with our current system it is simply too easy for intermarket abuses to slip through the cracks because of the dispersion of regulatory responsibility. Integrated regulation would enhance surveillance, facilitate intermarket rulemaking, and promote accountability.

Market Mechanisms. Secretary Brady has often cited the problems created by conflicting rules applying to fundamental market mechanisms, including unharmonized margin requirements, uncoordinated circuit breakers, inconsistent short selling rules, and discrete clearance and settlement systems. Taken together, they foster excessive volatility, heighten risk, and drive investors away from markets.

For example, low futures margins indirectly permit high leveraging in stocks. This leverage creates the potential for major market disruptions, starting in the futures market and washing back to the stock market. The active use of this leverage has the potential, when concentrated in short periods of time, to punch a hole in the fabric of the market.

Likewise, uncoordinated circuit breakers and clearance and settlement systems can risk major market disconnections. Coordinating these and other market mechanisms demands a more unified approach.

Globalization. The clear trend toward globalization of financial markets has now been recognized. I have already discussed how this overseas competition demands that the United States take the steps necessary to foster domestic innovation. But it also requires viewing interrelated domestic markets in a global context and speaking with one voice to our foreign counterparts.

Secretary Brady, testifying before the full Banking Committee last October, described the growing interdependence of the world's financial markets and supported the idea of identifying particular issues where an international and intermarket approach would be useful. Integrating "one market" regulation in the U.S. would obviously facilitate the process. In addition, integrated regulation would enable us to deal more effectively with foreign governments by speaking in a unified and consistent way.

Recommended Solutions

In short, what we now have is a single market with uncoordinated and even conflicting regulation. That may have created benefits in the past when markets were less connected and overseas competition was minimal. But now it creates problems, as I have just described.

The solution is not complicated, though it may be difficult to put in place. We do not need more regulation. But we do need to move toward more unified regulation as the umbrella under which specific intermarket issues can be much more easily resolved. The result will be more streamlined and efficient regulation.

In the past we have tended to focus too narrowly on piecemeal solutions to particular problems. This has been only partly successful, and it would be a mistake to continue solely down this path. The Market Reform Act, harmonized margins, and jurisdiction over new products are each important issues that need addressing. But they are all pieces of a systemic problem that requires a systemic solution.

Obviously, the broadest solution would be to merge the SEC and the CFTC. This would make our regulatory system similar to our major foreign competitors. Moreover, by unifying all regulation we could address not only the intermarket issues we now recognize, but new ones that are bound to arise as innovation continues.

A different solution would be to unify regulation of those markets that are particularly connected. This could range from unified regulation of all financial products and their derivatives to unified regulation of stock-related products.

We believe that the minimum course of action would be to unify regulation of stocks, stock options, and stock index futures under the agency with the greatest overall expertise in the combination of these products, the SEC. Margin authority over each of these products would also require consolidation in a single regulator. In addition, it is imperative that we end the jurisdictional disputes over the regulation of new products that simply drive them to overseas markets (this would require elimination of the "exclusivity" clause in the Commodity Exchange

Act, which currently requires exclusive CFTC regulation of any instrument that has any element of "futurity").

This minimum solution would deal comprehensively with the most prominent problems we now face. Moreover, because index futures are only a small percentage of the transactions regulated by the CFTC, it would not be a radical departure from the existing regulatory scheme.

Indeed, we believe that any more limited approach will only delay the resolution of intermarket problems that must be addressed. Indeed, if this minimum approach cannot be accomplished soon, it seems very likely that we would be forced to adopt a complete merger approach at a later time in response to new major market disruptions.

Conclusion

In conclusion, the benefits of unified regulation are substantial. While we embrace this approach, I want to emphasize our belief that today's problems do not come from the regulators themselves. Both the CFTC and the SEC are doing a good job under difficult circumstances -- administering a scheme of regulation that simply is not designed for the unified marketplace they are expected to regulate. We believe the answer is a coherent regulatory structure that can deal effectively with unified markets. Resolving regulatory fragmentation will promote investor confidence, which is a key to our long-term competitiveness.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions the Subcommittee may have.

* * * * *

Senator **Dodd**. Thank you very much, Mr. Glauber. We appreciate your comments.

Alan Greenspan, as I said, has been before this committee on countless occasions. I thank you once again for being with us this morning.

Mr. Chairman, having read your testimony, I gather this is testimony from the Board. You are representing the Board here rather than your own personal views.

Am I correct on that?

Mr. **Greenspan**. I would say I am representing the Board, and obviously, individual members of the Board have variations in views. On certain key issues, they have quite different views.

In my prepared testimony, I am reflecting the consensus of the Board.

Senator **Dodd**. But you won't be surprised if—when you conclude I ask you how you personally feel about some of these things?

Dr. **Greenspan**. I would be shocked if you didn't. [Laughter.]

Senator **Dodd**. Thank you.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Dr. **Greenspan**. Mr. Chairman, as always, it is a pleasure to appear before this committee and especially this subcommittee.

I plan to excerpt from my prepared text and request that my full remarks be included in the record.

Senator **Dodd**. Thank you.

Dr. **Greenspan**. I would like to focus this morning on three major issues: first, the adequacy of margin requirements on stock index futures as a prudential safeguard and the impact of existing margin-setting procedures and other differences in regulation on market volatility; second, existing impediments to innovation; and third, whether there is a need to modify the existing regulatory system for stocks and stock derivatives.

The Federal Reserve Board does not believe that the existing division of regulatory authority has increased volatility in the securities markets, nor in this regard is it a threat to the capital formation process. Volatility in equity markets rather reflects economic fundamentals and changes in financial processes prompted by technological advances and the increase in concentration of assets in institutional portfolios. Efforts to restrain volatility by imposing more restrictions on particular markets or instruments could have unintended effects resulting in significant costs on the system and a shifting of transactions activity offshore.

We continue to view the primary purpose of margins to be to protect the clearing organizations, brokers and other intermediaries from current losses that could jeopardize contract performance. As such, they are one important element of a package of prudential safeguards, including capital requirements, liquidity requirements and operational controls, aimed at limiting the vulnerability of the financial markets to losses or disruptions arising from the failure of one or more key participants.

The Federal Reserve Board remains skeptical, however, of whether in setting margins on stock index futures at levels higher than necessary for prudential purposes will reduce excessive stock price volatility. Although available statistical evidence on the relationship between margins and stock price volatility is mixed, the preponderance of that evidence suggests that neither margins in the cash markets nor in the futures markets have affected volatility in any measurable manner.

Thus, in the Board's view, the critical question is whether margins on stock index futures have been maintained at levels that are adequate for prudential purposes. We have concerns about the tendency for exchanges to lower margins on stock index futures to such a degree in periods of price stability that they feel compelled to raise them during periods of extraordinary price volatility. In the Board's view, somewhat higher margin levels would obviate the need to raise them in a crisis and thereby reduce concerns about the reliability of our market mechanisms, especially clearing and payment systems, in times of adversity.

The Board believes that Federal oversight is appropriate to ensure that margins on stock and stock index futures are established at levels that are adequate under a wide range of market conditions. The appropriate Federal agency should have both the authority to initiate changes in margins on stock index futures and the authority to veto changes proposed by the relevant SRO.

Either the CFTC or the SEC could play this role. On this jurisdictional issue, there are different views among Board members, but we agree that the Federal Reserve should not be given authority for futures margins and that our existing authority for stocks and stock options should be transferred to the SEC. The principal argument in favor of assigning oversight responsibility for stock index futures to the CFTC is that it has overall responsibility for prudential supervision of futures exchanges and clearing organizations and futures commissioned merchants. The principal argument for assigning oversight responsibility for stock index futures margins to the SEC is that it would foster consistency of margins in the stock and stock-derivative markets. The Board believes that margins in these markets should be consistent in the sense that they provide comparable protection against adverse price movements.

The degree of protection provided by margin requirements depends on the magnitude of potential future price volatility. Although studies of past price movements can shed light on potential movements in the future, the forecasting of future volatility necessarily involves elements of judgment. Because different agencies are likely to come to different judgments, there is a case to be made for having only one regulator with margin authority over all the equity products markets to achieve consistency of margins across these markets.

The Federal Reserve Board has certain concerns about the adequacy of our current regulatory system as it relates to product innovation. Many of the new products being developed on futures and options markets are not easy to classify. They have important similarities to or are otherwise linked to a variety of existing instruments subject to different regulators; and as a consequence, various uncertainties and frictions have emerged about the appropriate exchanges that should trade these instruments and the agencies that should provide regulatory oversight. One frequently cited example, the one discussed this morning, is the index participation or IP contracts. But the problem is broader than IP's. Under the Commodities Exchange Act, any commodity contract with an element of futurity cannot be entered into except on a CFTC-regulated exchange. Moreover, this act defines the term "commodity" very broadly to include not only physical commodities but also financial instruments. This restriction, when interpreted broadly, serves to discourage the development of new financial products that might be offered outside of the futures exchanges and tends to stifle the innovation process.

In a very general sense, all financial instruments have an element of futurity in them, in that the value depends on future events. We believe the Commodities Exchange Act can be modified in ways that preserve the public safeguards that motivated this provision, while preventing conflicts in this area from having to be dealt with by the courts and without impeding the process of innovation in equity and other instruments.

As I have noted, a case can be made for having only one Federal agency with oversight authority over margins in equity and equity derivative markets. Others would go farther and transfer all regulatory authority over stock index futures or options on such futures to the SEC. This is one of the possibilities recently identified by Treasury Secretary Brady.

This alternative would help achieve consistent prudential regulation across all these tightly linked markets for equity instruments. However, such a measure would result in two regulators of futures exchanges and futures clearinghouses, and hence would still require a considerable amount of coordination on the part of the SEC and CFTC. One must recognize that stock index futures are but one of many futures contracts offered by these organizations, indeed, only one of many financial futures contracts. Should losses from stock index futures trading—to be subject to SEC regulation under this alternative—jeopardize the financial integrity of a clearing organization or futures brokerage firm, it would threaten contract performance on all of the futures traded by the entity, including tangible commodity futures. Similarly, a failure in the commodities futures markets could, because of the effects on the clearing organization or brokerage, have consequences for equity markets.

Secretary Brady also has suggested much more far-reaching measures to deal with the jurisdiction issue—the transferring of all financial products to the SEC or the merging of the two agencies. We would urge caution in considering these alternatives. The full merger of the two agencies would avoid many of the problems just mentioned about overlapping jurisdiction in the regulation of exchanges and clearinghouses, and the transfer of all financial instruments to the SEC might be accompanied by the separate clearing of all financial futures subject only one regulator. However, these solutions would concentrate a great deal of regulatory authority over the financial system in a single agency and this has been a concern of Congress for a long time. We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments our financial markets have been the most innovative in the world, with many of the new products spurred by the introduction of index futures and other futures.

Thank you.

[The complete prepared statement of Alan Greenspan follows:]

For release on delivery
10:00 a.m., E.S.T.
March 29, 1990

Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Securities

of the

Committee on Banking, Housing, and Urban Affairs

U.S. Senate

March 29, 1990

Mr. Chairman, members of the subcommittee, it is a pleasure to appear on this panel this morning to discuss issues involving the regulation of securities markets. While your committee is addressing a broad range of matters in this area, you have asked me to focus on whether the existing split regulation of equities and index futures may have contributed to market volatility, interfered with the process of innovation, or led to enforcement problems. You also have asked for comment on certain proposals for regulatory consolidation. I would like to focus my remarks on three major issues: first, the adequacy of margin requirements on stock index futures as a prudential safeguard and the impact of existing margin-setting procedures and other differences in regulation on market volatility; second, existing impediments to innovation; and third, whether there is a need to modify the existing regulatory system for stocks and stock derivatives. My evaluation will be done against the objective of a regulatory structure that, while limiting risks to the system, results in highly efficient and innovative U.S. financial markets that can compete effectively in the global marketplace.

As I will discuss in more detail, the Board does not believe that the existing division of regulatory authority has increased volatility in the securities markets, nor in this regard is it a threat to the capital formation process. We continue to view the primary purpose of margins to be to protect the clearing organizations, brokers, and other intermediaries from credit losses that could jeopardize contract performance. While we think that federal oversight of margins is appropriate for prudential purposes, there are different views among

Board members on whether that authority is best vested in the Commodity Futures Trading Commission (CFTC) or the Securities and Exchange Commission (SEC).

On the broader issue of consolidating jurisdiction for stocks and stock index futures (or all financial futures) in one agency, there are good arguments for and against such a consolidation and, accordingly, differences of views on whether such consolidation would, on balance, be beneficial. We believe some changes to the existing regulatory system are necessary to avoid the prospect that jurisdictional disputes among regulators will impede innovation in our financial markets, but consolidation of jurisdiction is not necessary to achieve this objective.

Federal Margin Regulation

A prominent area of disagreement among those interested in the smooth functioning of our capital markets has been the appropriate level of margins for stock index futures and the need for federal authority over such margins. In part, these disagreements reflect different views as to the purposes of margins and the appropriate objectives of federal margin regulation. Accordingly, at the outset I would like to clarify the position of the Board of Governors on these issues.

We continue to believe that the primary objective of federal margin regulation should be to protect the financial integrity of market participants and thereby ensure contract performance. Margins should be adequate to protect clearing organizations, brokers, and other lenders from credit losses arising from changes in securities prices. As such, they are one important element of a package of prudential safeguards, including capital requirements, liquidity requirements, and operational controls, aimed at limiting the vulnerability of the financial markets to losses or disruptions arising from the failure of one or more key participants. The failure of, or even the loss of public confidence in, a major intermediary in any of the stock, futures, or options markets could immediately place significant strains on other markets, their clearing systems, and on our nation's payment system.

The Board remains skeptical, however, of whether setting margins on stock index futures at levels higher than necessary for prudential purposes will reduce excessive stock price volatility. We, too, are concerned about what seems to be a higher frequency of large price movements in the equity markets, but we are not convinced that such movements can be attributed to the introduction of stock index futures and the opportunities they offer for greater leverage. Although available statistical evidence on the relationship between margins and stock price volatility is mixed, the preponderance of that evidence suggests that neither margins in the cash markets nor in the futures markets have affected volatility in any measurable manner. Moreover, we are concerned that raising maintenance margins on stock index futures to levels well above those necessary for prudential purposes could substantially reduce futures market liquidity or drive business offshore.

Thus, in the Board's view, the critical question is whether margins on stock index futures have been maintained at levels that are adequate for prudential purposes. Although no futures clearing house has ever suffered a loss from a default on a stock index futures contract, certain actions by futures exchanges and their clearing houses in recent years raise questions about the adequacy of futures margins from a public policy perspective. Specifically, we have concerns about the tendency for these organizations to lower margins on stock index futures to such a degree in periods of price stability that they feel compelled to raise them during periods of extraordinary price volatility. While such a practice has heretofore protected the financial interests of the clearing houses and their members, it tends to compound already substantial liquidity pressures on their customers, on lenders to their customers, and on other payment and clearing systems. In the Board's view, somewhat higher margin levels on stock index futures would obviate the need to raise them in a crisis and thereby reduce concerns about the reliability of our market mechanisms, especially clearing and payment systems, in times of adversity.

The Board believes that federal oversight is appropriate to ensure that margins on stocks and stock index futures are established at levels that are adequate under a wide range of market conditions. Futures self-regulatory organizations (SROs) should continue to have primary responsibility for developing and refining margin policies. But the appropriate federal agency should have both the authority to initiate changes in margins on stock index futures and the authority to veto changes proposed by the relevant SRO. That authority should not be limited to emergency authority such as the CFTC currently has over futures margins.

Either the CFTC or the SEC could play this role. The principal argument in favor of assigning oversight responsibility for stock index futures to the CFTC is that it has overall responsibility for prudential supervision of futures exchanges and clearing organizations and futures commission merchants (FCMs). Assignment of oversight responsibility to the CFTC would avoid certain regulatory burdens and potential conflicts that could arise if responsibility for critical aspects of prudential oversight of such entities were divided between the CFTC and SEC.

The principal argument for assigning oversight responsibility for stock index futures margins to the SEC is that it would foster consistency of margins in the stock and stock derivative markets. The Board believes that margins in these markets should be consistent in the sense that they provide comparable protection against adverse price movements. The degree of protection provided by margin requirements depends on the magnitude of potential future price volatility. Although studies of past price movements can shed light on potential movements in the future, the forecasting of future volatility necessarily involves elements of judgment. Because different agencies are likely to come to different judgments, there is a case to be made for having only one regulator with margin authority over all the equity products markets to achieve consistency of margins across these markets.

On balance, the Board does not see a clear basis for choosing between CFTC and SEC oversight of stock index futures margins. The Board feels strongly, however, that authority should not be given to the Federal Reserve because it does not have overall prudential responsibility for any of the futures commission merchants (FCMs), broker/dealers, or clearing organizations that margins are intended to protect. The existing margin authority for stock and stock options assigned to the Board under the Securities Exchange Act of 1934 should be transferred to the SROs and the SEC.

Issues of Regulatory Jurisdiction

The question of regulatory responsibility for margins is one element of the broader question of regulatory jurisdiction over futures and options markets. In light of the strong linkages among the markets for futures, options, and their underlying instruments, some have argued that the division of oversight responsibilities among agencies may impede the effective regulation and supervision that is essential to ensure sound and efficient financial markets.

One particular concern relates to volatility. It is frequently argued that leveraged trading in stock-index futures and options, encouraged by low margin requirements on derivative products, has led to increased volatility in the prices of the underlying stocks. More generally, it has been suggested that other inconsistencies in market mechanisms involving, for example, circuit breakers and short-selling rules, contribute to market instability. It is feared that increased price volatility, in turn, will reduce the attractiveness of equity markets and could impede the capital formation process. These concerns have prompted calls for one regulator who will take steps to remove inconsistencies that may contribute to sharp price swings.

The Board does not share the view that split regulatory authority over equity instruments has in any meaningful way contributed to volatility. As I noted earlier, we have found no substantial evidence linking margin levels to price volatility in the cash or the index-product markets. Nor have studies revealed a clear understanding of how circuit breakers and other market rules affect price movements in the different markets.

In a more fundamental sense, we believe that it is counterproductive to lay blame on one sector, in this case the market for stock index derivatives, for the increasing occurrence of wide and rapid price swings in equity markets. Rather, the volatility we observe reflects more basic changes in economic and financial processes prompted by technological advances and the increasing concentration of assets in institutional portfolios. The delegation by the public of the management of a large proportion of its assets to professional managers through pension funds and other institutions and the desire of these managers for low-cost methods to manage risk and adjust portfolios has spurred growth in the new instruments; improvements in telecommunications and computer technology mean that information on economic fundamentals will be received and translated by these managers more quickly into market prices. To the extent that price movements reflect these basic forces, efforts to restrain volatility by imposing more restrictions on particular markets or instruments could have unintended effects, resulting in significant costs on the system and a shifting of transactions activity offshore.

A second issue frequently raised in evaluating the adequacy of our current regulatory system concerns product innovation. Many of the new products being developed on futures and options markets are not easy to classify. They have important similarities to, or are otherwise linked to, a variety of existing instruments subject to different regulators; and, as a consequence, various uncertainties and frictions have emerged about the appropriate exchanges that should trade these instruments and the agencies that should provide regulatory oversight. One recent example involves the "index-participation" or IP contracts that were introduced by several of the stock exchanges, approved by the SEC for securities trading and, in essence, disapproved when the courts ruled that IPs were futures products subject to the exclusive jurisdiction of the CFTC and could not be traded off of exchanges regulated by the CFTC.

Under the Commodities Exchange Act (CEA), any commodity contract with an element of futurity cannot be entered into except on a CFTC-regulated exchange. Moreover, this act defines the term "commodity" very broadly to include not only physical commodities, like corn and wheat, but intangible contractual interests, including financial instruments. This restriction, when interpreted broadly, serves to discourage the development of new financial products that might be offered outside of the futures exchanges and tends to stifle the innovation process. In a very general sense, all financial instruments have an element of futurity in them, in that their value depends on future events. We believe the CEA can be modified in ways that preserve the public safeguards that motivated this provision, while preventing conflicts in this area from having to be dealt with by the courts and without impeding the process of innovation in equity and other instruments. Such modifications might include an exemption for transactions subject to other regulatory safeguards, sophisticated trader exemptions, or more stringent fraud liability.

Alternative Regulatory Structures

As I have noted, a case can be made for having only one federal agency with oversight authority over margins in the equity and equity derivative markets. This case rests not on the issue of volatility but on the fact that setting prudential margins requires judgments concerning potential future price volatility in the linked markets for stocks and derivative products. One regulator would provide a single view of potential future volatility in these markets and thereby foster consistency of margins across the various segments of the equity markets. Others would go further and transfer all regulatory authority over stock index futures and options on such futures to the SEC. This is one of the possibilities recently identified by Treasury Secretary Brady.

This alternative would help achieve consistent prudential regulation across these tightly linked markets for equity instruments. However, such a measure would result in two regulators of futures exchanges and futures clearing houses, and hence would still require a considerable amount of coordination on the part of the SEC and CFTC. One must recognize that stock index futures are but one of many futures contracts offered by these organizations--indeed, only one of many financial futures contracts. Should losses from stock index futures trading--to be subject to SEC regulation under this alternative--jeopardize the financial integrity of a clearing organization or futures brokerage firm (FCM), it would threaten contract performance on all of the futures traded by the entity, including tangible commodity futures. Similarly, a failure in the commodity futures markets could, because of the effects on the clearing organization or brokerage firm, have consequences for the equity markets. In another area, many exchange rules related to trading and clearing cut across a wide range of contracts rather than being specific to stock index contracts, and close coordination between the SEC and CFTC would be important in evaluating such rules.

Thus, the SEC would have an important interest in other aspects of futures market regulation while the CFTC would continue to have a strong interest in the regulation of stock index futures. The logic of transferring stock index futures to the SEC because of their tight linkage to the cash market suggests that futures contracts on other instruments also might be regulated differently. That is, Treasury futures would be regulated by the Treasury and Eurodollar and foreign currency futures by the Federal Reserve. Such a change, however, would increase the regulatory fragmentation in the securities markets and would not appear to be a particularly useful realignment. Consequently, the benefits of transferring regulatory jurisdiction to the SEC for purposes of achieving more consistency of regulation across equity instruments must be balanced against these drawbacks, and there is scope for legitimate differences of view on whether such a measure would be a net improvement.

Secretary Brady also has suggested much more far-reaching measures to deal with the jurisdictional issue--the transferring of all financial products to the SEC or the merging of the two agencies. We would urge caution in considering these alternatives. A full merger of the two agencies would avoid many of the problems just mentioned about overlapping jurisdiction in the regulation of exchanges and clearing houses, and the transfer of all financial instruments to the SEC might be accompanied by the separate clearing of all financial futures subject to only one regulator. However, these solutions would concentrate a great deal of regulatory authority over the financial system in a single agency and this has been a concern of Congress for a long time. In addition to the potential management difficulties of a larger organization, there is the risk that bureaucratic inertia in a larger agency could be an impediment to the process of innovation. We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments, our financial markets have been the most innovative in the world, with many of the new products spurred by the introduction of index futures and other futures.

Senator HEINZ. Thank you, Chairman Greenspan. Mr. Breeden.

STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. BREEDEN. Thank you, Senator Heinz, Chairman Dodd, members of the subcommittee. Thank you for giving me this opportunity to address an issue of paramount national importance, the fragmentation of regulatory authority over the United States equity markets. Because these markets are the primary vehicle for raising capital in the United States, our resolution of this issue will have some implications for the future competitive health and stability of our securities markets, as well as for the overall U.S. economy.

Almost six decades ago, Congress created a comprehensive structure for the regulation of the Nation's securities markets. This structure was born out of the worst economic nightmare ever experienced by this country. As amended over the years, the Federal securities laws instruct the SEC to foster the "national public interest" by developing a "national market system for securities" and a "national system for the clearance and settlement of securities transactions." The Federal securities laws were also designed "to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the National Banking System and Federal Reserve System, and to insure the maintenance of fair and honest markets."

Thus, from the beginning, the mandate from Congress for the Securities and Exchange Commission has extended far beyond the promotion of specific segments of the market to broad considerations of a unified and effective national system of financial markets. The considerations enumerated by Congress—particularly facilitating a competitive national market and maintaining fair and honest markets—remain vital objects of financial regulation today.

As strongly as I care about maintaining the health and stability of the U.S. securities markets, I know that our colleagues at the CFTC care about maintaining the health and stability of the U.S. futures markets. There is a vital national interest in maintaining the strength and competitiveness of both the futures and the securities markets.

The issue, however, is not what is best merely for the securities markets or merely for the futures markets. Rather, the issue is how best to promote the interests of the American public in a safe and competitive financial system. New York and Chicago are important to that debate, but so are cities and towns all over the country, because each can be powerfully affected by failures in financial regulation or erosion of our international competitiveness. Unfortunately, the current system of fragmented regulation fails to serve the best interests of the American public as effectively as it could.

By splitting jurisdiction over the equities markets, we have placed the long-run health of our Nation's securities markets at risk. The regulatory division impedes effective regulation and hurts market stability. It drives some new products to offshore markets and has eliminated others completely. It reduces our ability to detect intermarket frontrunning and manipulation and to negotiate international agreements successfully with our global counterparts. In the other major markets—countries like Japan, the United Kingdom and France—the regulatory agencies do have responsibility for the whole picture—stocks, options and stock index futures.

Two problems are especially critical. First, the jurisdictional division between the SEC and the CFTC in some circumstances has hampered the development of new products in this country. As a result of the so-called "exclusivity clause of the Commodity Exchange Act," which has already been mentioned by both Bob and Alan and which provides that the CFTC has exclusive jurisdiction over any instrument that falls within the wide sweep of the term "contract for future delivery," three securities exchanges have been prevented from selling index participations, popularly known as "IP's". As a result, investors in the United States who want to buy IP's are prevented from doing so by an arbitrary jurisdictional dividing line.

This problem is not unique to IP's. The vast majority of banking, insurance and securities products have some element of futurity. It defies logic as well as public policy to suggest that these products, which may contain only some small degree of the characteristics of futures contracts, must be regulated as if they were purely a futures contract. Yet every one of these financial products may be subject to attack under the exclusivity clause given the current interpretation that has been given to that clause in the courts.

Sadly, we will never know exactly how many products never come to market as a result of this uncertainty. Many promising ideas may simply be dropped, because the cost of litigating over the regulatory treatment of a particular product may be too high.

The futures exchanges argue that they promote competition and innovation, and I would agree that they certainly have done so in many cases in the past. But what they sometimes don't say is that they have also used this exclusivity clause as a weapon to prevent competition and innovation by others.

If left unchecked, the current interpretation by the courts of the exclusivity clause could well do more long-term damage to the health and creativity of our securities markets than anything that has happened in decades. If the futures exchanges provide better products, then they won't be hurt by elimination of a legislated exclusivity clause, and they should be successful competing on an open and unrestrained basis with securities, banking and insurance products. When in doubt, we should promote competition in the markets, not kill it in an array of bureaucratic entanglements and endless litigation.

The second problem is that the differences in margins on equity products have increased instability in the securities markets. Under current law, securities margins are set by the Federal Reserve Board, while futures margins are established by the market participants, the futures exchanges themselves. As a result, while margins on securities transactions have been set at 50 percent since 1974, margins on stock index futures contracts have at times been close to zero. Thus, on the morning of October 13, 1989, an investor with $100,000 in cash could have held $200,000 worth of the S&P 500 stocks on the New York Stock Exchange, but the

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in emergency situations,[20] the CFTC does not have authority to set margins for futures contracts, including for stock index futures contracts. Instead, the power to set margin levels for futures contracts is explicitly and exclusively left to the futures exchanges.[21] Thus, margins for the S&P 500 futures contract are set by the CME which need not consider the views of any government agency.

Even adjusting for differences in settlement times and other operational variations between stock and futures markets, the margin requirements for stock index futures contracts are dramatically lower than those for equity securities. For example, on the morning of October 13, 1989, a day that saw the market plunge nearly 200 points (166 points in the last 90 minutes of trading), the maintenance margin requirement for both "hedging" and "speculative" transactions on the S&P 500 futures contract was only 2.26%. In contrast, the margin requirement for stocks on that morning was 50% of the stock's value, as it has been since 1974.[22] Thus, on October 13, 1989, an investor with $100,000 cash could have acquired a maximum ownership position of $200,000 value in the S&P 500 stocks.[23] However, the same investor with the same $100,000 could have bought S&P 500 futures contracts on the CME worth more than $4,424,000. Therefore, competition between the equity and equity index futures markets was not based on a superior product same investor, with the same $100,000, could have held a position worth $4,424,000 in the same stocks through positions in the S&P 500 futures contracts.

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[20] *See* 7 U.S.C. § 8a(9) (the CFTC may set "temporary emergency margin levels" with respect to any futures contract if it finds that an "emergency" exists and if it determines that such action "is necessary to maintain or restore orderly trading in or liquidation of" that contract).

[21] *See* 7 U.S.C. § 8a(7) (authorizing the CFTC to alter or supplement the rules of any futures exchange, including trading requirements, "except the setting of levels of margin").

[22] While specialists and other securities market makers may obtain loans collateralized by their market making securities on a "good faith" basis, the banks and broker-dealers that extend these loans usually require margin in the 20 to 25% range as collateral for the loans. Even the margins applicable to stock index options are much higher than margins on stock index futures. Since May 1988, the margin requirement for stock index options has been the option premium plus 15% of the underlying index value times the index multiplier.

[23] Regulation T allows investors five days to make their initial margin payment. Self-regulatory organization rules, however, restrict any customer from liquidating a position prior to having paid for it. Moreover, institutions generally do not use margin. Instead, they trade on a delivery versus payment basis, paying 100% of the value of the security.

This low margin requirement contributes heavily to excess levels of speculative trading. It can create an illusion of liquidity during normal market conditions, but that illusion disappears in a heartbeat when markets are stressed. When the market falls sharply, futures clearing corporations don't have a choice except to increase margins suddenly. As a result, when the market is already weak, liquidity is sucked out of the futures market. This creates the systemic risk that even greater selling pressure will be transmitted from the stock index futures market to the stock market. This could cause a cascading effect on stock prices and turn a temporary drop in the market into a deep plunge that could cause significant damage to the overall U.S. economy. This is not an issue of academic studies of average intra-day price volatility. It is an issue of whether our market has institutional safeguards by which the U.S. Government can appropriately protect the overall safety of the entire market system during times of extraordinary stress. Sadly, the current structure is not adequate, in my view, and can and should be improved.

Not one other major nation with active capital markets has a balkanized system of regulation such as ours. Thus, no other country absorbs the overhead and other costs we have imposed on ourselves due to the current system. Indeed, those who claim that eliminating the regulatory fragmentation in the U.S. market would drive futures trading offshore ignore the fact that the most significant foreign markets already have unified stock and stock index futures jurisdiction.

Since the commission's testimony describes each of these problems at length, I will not seek to repeat those detailed remarks. However, I want to emphasize that these problems are serious, they are growing, and they will not go away without a significant overhaul of the existing system. The time for Band-Aids and piecemeal solutions, in my judgment, is past. The time has come for a serious response to problems that, if left unresolved, create unnecessary risks of damage and cost to the American public.

I would add that this is not, in my judgment, a problem of failure of the SEC and CFTC to discuss these issues or to try and work within the existing structure. Some of these problems, particularly the exclusivity clause, are within the law itself. We don't have the power to waive the law or to vary it, and where the law creates risks in structures, it is our duty, in my judgment, to recommend improvements in the law to the Congress.

Certain fundamental principles should guide us in crafting a solution to this problem.

First, both the securities and futures markets operate in a globalized system with powerful foreign competition, and we should not take steps that will make the United States less competitive internationally in securities or in futures.

Second, overregulation can be as damaging as underregulation, and we must be extremely careful to achieve our regulatory objectives with the least possible restraint on competition and without unnecessary cost.

Third, competition should be based on products, prices, services and other business factors, not on artificial differences in regulation that distort the market and dictate the winners and losers irrespective of sound economics.

Fourth, there are significant potential costs to the public at large when financial regulatory systems prove inadequate. The public is entitled to expect that Government regulators and Congress alike will seek to identify systemic risks realistically and be willing to deal with them effectively.

Fifth, the time for action has arrived. The European Community is embarked on a serious and sustained effort to eliminate all financial regulatory barriers between 12 sovereign nations, let alone between stocks and stock index futures within the same country. Modernization of the overall U.S. system, including the Glass-Steagall Act, the Bank Holding Company Act, deposit insurance and many other issues, is long overdue. If we want to retain our financial market leadership, and I think everybody in the committee and here at the panel agrees with that objective, we need to muster the vision and the will to act with respect to these issues.

The commission's testimony discusses measures to deal with the risks created by the present regulatory system.

First, we believe that the exclusivity clause of the Commodity Exchange Act should be repealed or substantially overhauled. There is not any sound public policy reason for products that are regulated by Federal banking or securities authorities as banking and securities products to be barred from the marketplace as a result of litigation over this statutory boundary.

Second, give a single Federal agency—we prefer the Federal Reserve Board—authority for margins over stocks, stock options, and stock index futures. Alternatively, Congress could set a minimum level for all margins, what I have called a national speed limit, that would require joint action by the SEC and the CFTC to lower that minimum standard.

Third, I share the view of Treasury Secretary Brady that, at a minimum, there should be a transfer of jurisdiction over stock index futures to the SEC, thereby restoring the single regulator for the equity markets that was originally intended by Congress. This would end, once and for all, the jurisdictional debates. It would permit significant efficiencies for introducing new products on stock and futures exchanges. It would also allow reduced costs and bureaucracy for the participants in the markets, who could register with one agency rather than two different ones.

The object of this plan is not to harm the futures industry or the futures markets. The object is to promote competition, to increase stability, and to reduce unnecessary risks to the public. Absent these actions, we face serious damage to our vital markets and the steady erosion of U.S. world market share and financial leadership.

Thank you.

[The complete prepared statement of Richard C. Breeden follows:]

TESTIMONY OF

RICHARD C. BREEDEN,
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

BEFORE THE SUBCOMMITTEE ON SECURITIES
OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

CONCERNING INTERMARKET REGULATION

March 29, 1990

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING INTERMARKET REGULATION

BEFORE THE SECURITIES SUBCOMMITTEE OF THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

MARCH 29, 1990

Chairman Dodd and Members of the Subcommittee:

It is my pleasure to appear before you today to express the views of the Securities and Exchange Commission concerning the issue of maintaining the integrity and unity of regulation of the equity capital markets of the United States, including regulation of trading in stocks, options, and stock index futures.

I. INTRODUCTION

The Committee's determination to re-examine the fundamental assumptions underlying the regulatory structure of the equities markets is extremely timely. For nearly sixty years, the SEC has sought to carry out our mandate from Congress. That mandate is as important today as it was when first enacted.

The fulfillment of that mandate has been made more difficult by the regulatory structure. Unlike every other country with developed capital markets, the U.S. alone divides regulation of equity securities from regulation of derivatives on equity securities. The extra costs created by this structure fall only on U.S. financial markets. The Commission believes that Congress should consider whether the regulation of different parts of the same market by separate agencies is in the national interest. Even though the stock, stock options, and stock index futures markets are fundamentally interlinked, they are currently regulated as if they were separate markets. On the whole, this regulatory bifurcation has a negative impact on our nation's financial system.

The current fragmentation of regulation of the equity securities market is stifling or driving new products to overseas markets. Resources of regulators and market participants are expended on efforts to resolve jurisdictional uncertainties, rather than on developing new products and improving U.S. competitiveness.

The fragmenced U.S. structure also interferes with our ability to ensure systemic stability in the nation's securities markets and makes it more likely that market participants can engage in intermarket frontrunning and manipulation without detection.

Finally, the bifurcated regulatory structure makes it more difficult to develop favorable international regulatory approaches to issues of both stability and competition in the world's financial markets.

Congress can solve these problems by revising the regulatory structure in order to reflect the realities of the marketplace. In any such revision, what are plainly integrated financial markets should be regulated by a single agency. That result could be accomplished in its most critical area by unifying the regulation of the stock and stock index futures markets. However, this problem could also be solved by consolidating all regulation over the securities and futures markets.

Before turning to jurisdictional issues, I would like to stress one thing. In my opinion, the Commissioners and staff of the Commodity Futures Trading Commission ("CFTC") are dedicated professionals, and they have worked diligently to achieve the goals Congress has set for regulation of the futures markets. The SEC Commissioners and staff are not better, or smarter, than their CFTC counterparts. Rather, the regulatory problems we are discussing arise because of a fundamental and serious structural weakness in the current system. Similarly, our objective in proposing reforms is not to benefit the stock market at the expense of the market for stock index futures. Rather, we seek to suggest means of improving the regulation of both equities and derivatives on equities, and to promote the overall public interest in stable and competitive financial markets.

II. THE RELATIONSHIP BETWEEN THE STOCK AND STOCK INDEX FUTURES MARKETS

The bifurcated regulatory structure for securities and futures impacts a broad range of investment products and market professionals. Given the critical importance of the stock market for capital formation, job creation and productivity growth in the United States, however, this testimony will focus on the interrelationship of the stock, stock options, and stock index futures markets.

In most fundamental respects, the markets for stocks, stock options, and stock index futures are directly linked. The economic forces that affect prices, that affect the investment banks and institutional investors that are the major participants, and that affect the trading strategies used by market participants are closely interrelated. What affects one of these markets will almost inevitably affect the others. Indeed, the Presidential Task Force on Market Mechanisms found that "what have been traditionally seen as separate markets -- the markets for stocks, stock index futures, and stock options -- are in fact one market."[1]

Intermarket trading strategies also ensure that the markets move in tandem. For example, as a result of index arbitrage, stock index futures price movements are passed directly through to the stock market. In addition, stock index futures trading impacts the behavior of participants in the stock markets as well as the intermarket trading strategies they employ.

As a result of a variety of factors, including increasing institutionalization of the securities markets and the leverage allowed for stock index futures, the stock index futures markets assumed a major price discovery function for the stock market during the last decade. Though stock index futures began as a hedging vehicle for investors in the stock market, their function has changed as the volume of stock index futures trading has grown.[2] As a result, prices in the stock index futures market have become the engine that sometimes drives pricing in the stock market, even for those stocks that are not part of an index that underlies a futures contract. Because prices are in a real sense being set in both the cash and derivative markets, index arbitrage and a variety of other sophisticated trading techniques have developed to force the divergent movements in the separate markets toward "linkage."

III. THE DEVELOPMENT OF THE CURRENT REGULATORY STRUCTURE

The current bifurcation of regulatory responsibility between the stock and futures markets traces back to 1974, when the CFTC was created. Historically, futures markets were developed to provide a centralized hedging and price discovery mechanism for agricultural commodities such as corn and soybeans. As a result, the scope of the Commodity Exchange Act ("CEA") was limited to certain specifically enumerated commodities, and regulatory authority was vested in the Commodity Exchange Authority, a bureau of the Department of Agriculture.

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[1] Report of the Presidential Task Force on Market Mechanisms (January 1988) ("Brady Report") at 55.

[2] COMPARISON
OF AVERAGE DAILY DOLLAR VALUE OF VOLUME
OF S&P 500 FUTURES AND NYSE STOCKS

YEAR	S&P 500 FUTURES	NYSE STOCKS
1984	$ 3.6 billion	$3.0 billion
1987	$10.0 billion	$7.4 billion
1988	$ 6.7 billion	$5.6 billion
1989	$ 6.7 billion	$6.1 billion

This structure was changed in 1974, when Congress enacted the Commodity Futures Trading Commission Act (the "CFTC Act"). As part of that statute, Congress established the CFTC as an independent regulatory agency with broad authority over the futures markets. It also expanded the coverage of the CEA dramatically by redefining the term "commodity" to include "all other goods and articles ... and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[3]

The CFTC Act also granted the CFTC "exclusive jurisdiction" with respect to "transactions involving contracts of sale of a commodity for future delivery."[4] In order to preserve SEC jurisdiction over transactions in securities, however, Congress added a provision to the CEA, known as the "SEC savings clause," providing that the CEA's broad new coverage was not intended to "supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission."[5]

Despite Congress' attempt to preserve the SEC's pre-existing regulatory authority, the authority granted to the CFTC soon led to jurisdictional problems. In September 1975, the CFTC approved an application by the Chicago Board of Trade (the "CBT") to trade futures contracts on Government National Mortgage Association ("GNMA") securities. Rejecting the SEC's arguments that futures contracts on securities were themselves securities,[6] the CFTC asserted that the language of the CEA demonstrated that Congress had intended to give it exclusive jurisdiction over all trading in futures, including futures on securities.[7] As a result, futures on GNMA securities and other government and private debt instruments began to trade on futures exchanges.[8]

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[3] 7 U.S.C. § 2(a)(1)(A).

[4] Id. (emphasis supplied).

[5] Id.

[6] See Letter from Roderick M. Hills, Chairman, SEC, to CFTC (Nov. 13, 1975), reprinted in [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,117, at 20,829.

[7] See Memorandum of the Office of General Counsel of the CFTC [Date], reprinted in [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,117, at 20,837.

[8] In 1978, the jurisdictional issue was raised before Congress during the CFTC's reauthorization hearings. At that time, Congress did not modify the jurisdictional provisions of the CEA, but amended the CEA to require the CFTC to seek the SEC's views with respect to CFTC activities that related to the SEC's regulatory

This jurisdictional problem resurfaced in 1981, when the SEC approved an application by the Chicago Board Options Exchange (the "CBOE") to trade options on GNMA certificates. The CBT challenged this decision, claiming that a GNMA certificate was a commodity under the CEA, and that options on such certificates fell within the exclusive jurisdiction of the CFTC. The SEC asserted that GNMA certificates were securities, that options on such securities were also securities, and thus that the SEC was the appropriate regulatory authority for such instruments, particularly since the CBOE intended to trade those options on a securities exchange.

The United States Court of Appeals for the Seventh Circuit found in favor of the CBT,[9] but the case was rendered moot as a result of legislation enacted when the SEC and CFTC settled the underlying dispute. This agreement, frequently termed the SEC/CFTC Jurisdictional Accord (the "Accord"), was enacted into law in 1982 and 1983. It was designed to resolve the statutory ambiguities concerning the SEC's and the CFTC's respective jurisdictions and thereby to encourage the development of new financial instruments in both the securities and the futures markets.

In order to accomplish these goals, the Accord reaffirmed the SEC's jurisdiction over options on securities and options on indexes of securities, as well as the CFTC's jurisdiction over futures (including futures on certain indexes of securities) and options on futures. In addition, the Accord gave the SEC a significant role with respect to the approval of new stock index futures. As a result of the Accord, the CFTC may not permit the trading of a new stock index future unless the SEC determines that the index is (i) settled in cash, (ii) not readily susceptible to manipulation, and (iii) broad-based and widely published. The Accord did not, however, otherwise change the definition of the term "future" under the CEA or revise the exclusivity provision, thereby leaving open for the future jurisdictional issues regarding new products as they were developed.

IV. PROBLEMS CAUSED BY FRAGMENTED REGULATORY JURISDICTION

The fragmentation of regulatory responsibility over the equities and derivative markets has significantly impeded the regulatory programs of both the SEC and the CFTC. As discussed in detail below, the jurisdictional split has made enforcement of the securities and commodities laws more difficult and regulation of the securities and futures markets less coherent and more expensive. In addition, the fragmentation of regulatory authority

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responsibilities. 7 U.S.C. § 2(a)(8)(B).

[9] Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137 (7th Cir. 1982), vacated as moot, 459 U.S. 1026 (1982).

has hurt U.S. competitiveness in the growing international markets and has hampered our efforts to negotiate cooperative agreements with regulators from other countries. As a result, the problems generated by the current separation of regulatory responsibility have placed great strains upon both agencies' ability to maintain the stability and integrity of our nation's securities and futures markets.

A. Maintaining U.S. Competitiveness

The jurisdictional fragmentation of the U.S. equity market damages the competitiveness of the U.S. securities markets in the global marketplace. As a result of jurisdictional disputes, innovative new products have been prevented from trading or have been driven offshore. A striking example of the degree to which the competitiveness of the U.S. securities market has been adversely impacted is provided by the so-called "IPs" decision.

1. Index Participations ("IPs")

The IPs controversy began in 1988 when the Philadelphia Stock Exchange (the "Phlx") applied to the SEC to trade a product known as Cash Index Participations. Shortly thereafter, the American Stock Exchange (the "Amex") and the CBOE filed similar proposals. All three of the proposed IPs products were instruments with no expiration date based on the present value of a basket of securities, such as the stocks in the S&P 500. The buyer of an IP purchased the right to receive the present value of the S&P 500 as well as, at the end of each quarter, the proportional value of the dividends that stocks in the index paid during that quarter. Concomitantly, the seller of an IP received the full purchase price, but incurred the obligation to make the dividend payments to which the buyer was entitled. The buyer of an IP could do so on a margin basis in the same manner as a purchaser of stock. A position in an IP could be closed out either by buying or selling an offsetting position or by exercising a cash-out privilege, the terms of which varied among the three instruments.

The SEC unanimously voted to approve these products for trading as securities under the Securities Exchange Act of 1934, based on a determination that they qualified under the definition of securities. The Commission found that while IPs possessed some attributes of a futures contract -- as do virtually all financial instruments -- they lacked the key characteristics of futurity and bilateral obligation.

The Chicago Mercantile Exchange (the "CME") and the CBT challenged the authority of the three stock exchanges to offer IPs, claiming that IPs were futures contracts, and thus could not be traded except on a futures exchange. After the SEC concluded that all three IPs were securities within the meaning of the federal securities laws and were not futures contracts subject to the CEA,[10] the futures exchanges filed suit in the United States Court of Appeals for the Seventh Circuit to overturn the Commission's approval order, and the CFTC filed a brief amicus curiae in support of their position.

In a decision handed down last August, the Seventh Circuit deferred to the CFTC's finding that IPs were futures within the meaning of the CEA, and held that, "if an instrument is both a security and a futures contract, then the CFTC's jurisdiction is exclusive."[11] Although it recognized that it was giving "the futures markets the opportunity to block competition from an innovative financial product," the court ruled that, under the CEA, IPs could not be traded other than on a futures exchange.[12]

As a result of this interpretation of the CEA's exclusivity provision, it is most unlikely that any U.S. securities exchange will trade, or any corporate issuer will issue, any new security that may even be argued to include any element of a futures contract. This result may or may not be a correct literal interpretation of the existing statute. However, if it is a correct decision, then this provision of the CEA could do incalculable damage to the U.S. securities markets.

First, it is not logical to require a product, which is 99% a security and 1% a future, to be regulated solely as a future. This would make the equity markets, where capital is raised to produce new plants, equipment, and jobs, subservient to the futures markets, which provide only "risk shifting."

Second, the result appears to require products with hybrid features to be traded in the "open outcry" futures pits, even though many products are manifestly unsuited to that form of trading.[13]

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[10] Securities Exchange Act Release No. 26709 (April 11, 1989), 54 FR 15280.

[11] Chicago Mercantile Exchange v. SEC, 883 F.2d 544, 548 (7th Cir. 1989), petition for cert. pending.

[12] Id. at 548-49.

[13] Debt securities are primarily traded in the over-the-counter ("OTC") market by competitive dealers. Because individual corporate debt securities are often inactive, the continued "sponsorship" by OTC market makers (who often participated in the underwriting of the security) is critical to ensuring reasonable levels of liquidity.

Third, the public interest in competition is undercut by conferring a form of monopoly protection on boards of trade. There is not a viable public policy reason for products regulated by federal banking or securities authorities as banking or securities products to be barred from the marketplace as a result of litigation by the futures industry.

Finally, we must ask where this principle of exclusivity will stop. All interest rate swaps offered by banks involve futurity.[14] Unquestionably all insurance contracts are in fact "futures" contracts. Should the traders at the Chicago Board of Trade and the Chicago Mercantile Exchange have monopolies on trading these products as well?

I believe that there is a public interest in strong futures exchanges. Futures products perform useful economic functions, and they should be regulated in a manner appropriate to the development of strong, stable and globally competitive markets. However, these interests must be accommodated in a manner that does not damage securities, banking and insurance markets.

If we do not eliminate this anti-competitive element in the exclusivity clause, then there will be significant damage to U.S. markets and to the users of those markets.[15] Hundreds of investors bought the IPs products, undoubtedly for sound economic reasons. But today, as a result of the court's interpretation of the exclusivity clause, those products cannot be bought anywhere in the United States. Ironically, the CME and CBT fought to stop Phlx and Amex from being able to trade these products even though they were not trading them then, and they are not trading them now.

For the future, we will never know how many hybrid products are not developed because the threat of years of litigation will simply cause many hybrid products -- and even pure securities, banking, or insurance products that could be alleged to involve some minimal aspect of futurity -- never to be offered here in the United States. Sadly, not one of the markets with which the United States competes requires its new products to go to the courthouse before they go to the market. Therefore, the damage will be

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[14] While the present CFTC has exempted certain interest rate swaps from the CEA, any efforts to standardize the terms governing swaps apparently would subject them to futures regulation.

[15] It should be emphasized that the anti-competitive effects of this statutory bar to innovation cannot be addressed merely by allowing securities salespersons to sell IP products that are traded on a futures exchange. There are a number of institutional investors who are either legally restricted from trading futures or are unwilling to do so. Similarly, most individual investors do not participate in the futures market.

"exclusive" to U.S. markets, to the detriment of our international competitiveness. This is purely a self-inflicted wound.

2. Hybrid Instruments

The division of jurisdiction has also inhibited corporate issuers from developing innovative capital-raising techniques or has forced them to move certain financing techniques off-shore. In recent years, corporate issuers have begun to use hybrid instruments -- debt or equity instruments whose return is based, in whole or in part, on the price of a commodity or the value of a specified foreign currency or stock market index -- as an alternative to traditional capital-raising devices.

Because they can be tailored to meet the needs of the specific issuer, hybrid instruments have the potential in some specific applications to reduce the cost of raising certain types of capital. This may be particularly true if the issuer's results of operations may be significantly affected by price movements of a particular commodity. At the same time, certain investors may be willing to lend or invest for a smaller fixed return where they have additional contingent return based on movements of a commodity or index. An example of such a security might be a convertible bond issued by an oil company where the conversion price was calculated based on the price of crude oil rather than on the value of the company's common stock.

No matter what the purpose, however, the identity and financial health of the issuer is critical to an evaluation of the value of each hybrid product. Regardless of the product's structure, an investor's return depends on the issuer's ability to fulfill its obligations on the instrument. Therefore, a hybrid product is unlike a future in that the investor must evaluate the issuer as well as the merits of a return based in part on the value of an underlying commodity or index.

Placing hybrid instruments under the regulatory structure of the CEA would make many of them unattractive to issuers and investors. Because futures must trade on a futures exchange, while corporate debt instruments traditionally trade over-the-counter, the liquidity for such an offering would be predictably small if it were confined to trading in the open outcry futures exchanges.

The CFTC has long struggled over the appropriate treatment of hybrid instruments under the CEA. At first, the CFTC indicated an intention to regulate hybrid instruments as futures contracts or commodity options under the CEA.[16] As a result, many corporate issuers abandoned plans to issue new hybrid instruments, or instead chose to issue them offshore where they would not be subject to the CFTC's jurisdiction. After the SEC, the Treasury Department, and the Office of the Comptroller of the Currency, among others, objected to the CFTC's proposal,[17] the CFTC exempted (or interpreted out) certain hybrid instruments from regulation as futures or commodity options.[18] The restrictive conditions that the CFTC placed on the issuance of hybrid products, including issuer qualitative standards and restrictions on the value of any options-like feature of the product, still may prevent many hybrid products from being issued in the United States.

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[16] The CFTC published the advance notice of proposed rulemaking for comment in December 1987, 52 FR 47022 (December 11, 1987), and republished it for comment a month later in 53 FR 2310 (January 28,

B. Market Stability

The increased incidence of dramatic price movements that characterizes today's markets can be traced, in part, to the regulatory fragmentation that exists with respect to those markets. Because of that regulatory fragmentation, margin requirements in the stock and stock index futures markets are regulated in completely different ways.

With respect to the securities markets, the federal securities laws recognize that there is a strong public interest in establishing prudent margin levels. Thus, Section 7 of the Exchange Act[19] authorizes the Federal Reserve Board to set initial and maintenance margin requirements for all securities, other than exempted securities, that are purchased on credit. The limit on borrowing has been set at 50% since 1974. Indeed, a limit on speculation with borrowed funds was one of the safeguards for stability adopted in the wake of the stock market crash of 1929.

In contrast, margin levels on futures contracts, including stock index futures, are not subject to federal regulation. Except

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1988). The CFTC then published its notice of proposed rulemaking a year later in 54 FR 1128 (January 11, 1989).

[17] See Letter from David W. Mullins, Jr., Assistant Secretary, Domestic Finance, Department of the Treasury, to Wendy Lee Gramm, Chairman, CFTC (Apr. 19, 1989); Letter from Linda C. Quinn, Director, Division of Corporation Finance, SEC, to Marshall E. Hanbury and Paula Tosini, Co-Chairmen, Off-Exchange Task Force, CFTC (Nov. 17, 1988); Letter from J. Michael Shepherd, Senior Deputy Comptroller, Corporate and Economic Programs, Office of the Comptroller of the Currency, to Wendy L. Gramm, Chairman, CFTC (Feb. 27, 1989).

[18] See 54 FR 30,684 (July 21, 1989) (adopting final regulations with respect to hybrid instruments).

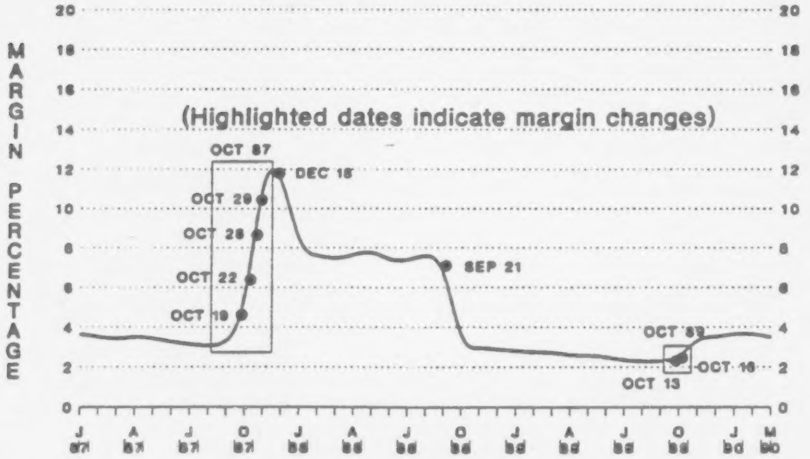
[19] 15 U.S.C. § 78g.

or service, but at least in substantial part was based on dramatically greater leverage.

To provide a better perspective regarding the absence of any federal margin requirements for index futures, it is helpful to see how index futures margin levels have been handled over time. As can be seen in the charts on the next page, margin levels on the S&P 500 futures contract prior to the October 1987 market break were approximately 2.9% for all hedging transactions (initial and maintenance), and 7% (initial) and 3.5% (maintenance) for speculative transactions. In response to the market crash in 1987, futures margins were raised to 12.2% of contract value on October 29, 1987 for hedging transactions (initial and maintenance) and 17.1% (initial) and 10.7% (maintenance) for speculative transactions. However, once the policy debates in Washington on margin levels were over, the margins were sharply cut. By May 4, 1989, margins had been reduced to 2.6% of contract value for hedging transactions (initial and maintenance) and 4.2% (initial) and 2.6% (maintenance) for speculative transactions.

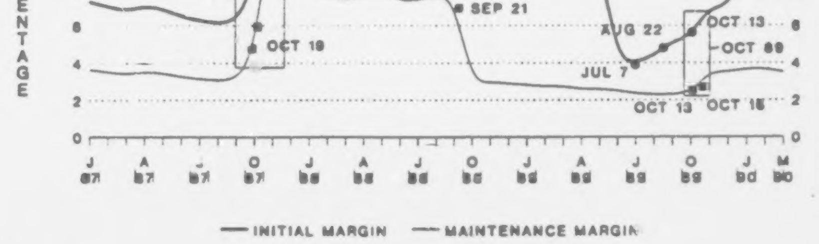
What these numbers show is that both in 1987 and again in 1989, the margins on stock index futures were set at levels that allowed market participants almost 22 times greater leverage than permitted for securities purchases. Because these levels were so low, at the first sign of serious market stress stock index futures margins were sharply raised, resulting in hundreds of millions of dollars in margin calls. This removed liquidity from the markets at the worst possible time. It also exposed the market to the risk that firms unable to meet margin calls might have to dump portfolios on the market. This created the risk of massive selling at the very time the danger of a further fall in the market was the greatest. This is not theory -- it happened, and it happened not once but twice. Even today, the initial margin requirement for hedging transactions on the S&P 500 future is still only 3.5% (only 10.2% for speculative transactions), as compared to 50% for transactions in the stock market.

FUTURES MARGIN REQUIREMENTS: HEDGE
Chicago Mercantile Exch S&P 500 Contract
January 1987 - March 1990



INITIAL and MAINTENANCE Margin
are the same throughout the period

FUTURES MARGIN REQUIREMENTS: SPECULATIVE
Chicago Mercantile Exch S&P 500 Contract
January 1987 - March 1990



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It is true that, in some respects, margins for stock index futures have different characteristics than margins for stock. For example, futures margin functions in part as a performance bond to ensure that each party to a futures contract performs his or her obligation. In contrast, stock margin represents an extension of credit. Despite this and other differences, however, both margins share an important characteristic in that they serve as collateral and "control the effective economic leverage available in [a] financial instrument."[24]

The low level of margin on stock index futures contracts has several adverse effects on the stock market. First, low margin contributes to speculative trading by highly leveraged participants. Under normal market conditions, this creates the illusion of greater liquidity in the futures markets. However, when market conditions become extreme, this artificial liquidity disappears swiftly. Under adverse conditions highly leveraged futures traders, whether voluntarily or when forced to do so by margin calls, exit the market quickly. As liquidity declines at a faster rate in the futures markets than in the stock markets, even more selling pressure is transmitted from the stock index futures market to the stock markets, thereby exacerbating price declines that may already be occurring in the stock markets.

Second, because extremely low margin levels expose futures clearing corporations to unacceptably high risks when markets become volatile, the clearing corporations must increase margin levels under these circumstances. This action compounds the impact of the market volatility by requiring extremely large additional margin payments from market participants. This places enormous pressure on the payment system and drains liquidity from the system just when it is most needed.

Third, low futures margin can endanger the entire financial system when markets are under stress. The lower the margin levels on futures contracts, the greater the possibility that margins will be raised swiftly during stress periods. This pulls liquidity out of the system when it is under the greatest strain. It also creates a risk that some market participants will be unable to meet margin calls, thereby leading to massive sales and even potential failure of a futures clearing entity. Potentially serious consequences could result for the overall financial system, as the ripples from such developments spread outward to other participants and other clearing entities.[25]

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[24] Brady Report at 64-65.

[25] The Presidential Working Group on Financial Markets found in May 1988 that then current margin levels were adequate for prudential purposes (i.e., providing an adequate level of protection to the financial system). Interim Report of the Working

Finally, while the direct impact of margins on daily volatility has not been established in most academic studies of the issue, the incidence of dramatic intra-day price movements remains a matter of serious concern. Substantial numbers of investors may be deterred from participating in our market due to fears induced by severe market movements.

C. Detecting and Prosecuting Intermarket Fraud

Fragmented regulatory jurisdiction also interferes with the fundamental responsibilities of the SEC and the CFTC to prevent fraud and to preserve market integrity. Under the present structure, the regulatory systems of both the SEC and the CFTC operate only in a portion of the interlinked markets. Often, two different agencies and their respective self-regulatory organizations must review separate parts of coordinated trading activity that crosses between markets. In that case, both agencies only see one-half of what is in fact a coordinated trade that begins in one market and ends in the other.

The subdivision of regulatory responsibility is a particular concern with respect to intermarket frontrunning[26] and manipulation. The existence of interlinked markets creates unique opportunities for manipulative or abusive trading. In particular, the substantially greater leverage available from stock index futures provides opportunities for market participants to profit from relatively small price movements in the underlying securities markets. When different agencies regulate separate segments of the same market there inevitably will be differences and gaps in regulation. In this environment, it is not likely that any system of fragmented enforcement authority will work as effectively as a single enforcement agency for a common market.

Group on Financial Markets, (May 1988) at 5 ("Working Group Report"). When this report was issued, however, stock index futures margins were at relatively higher levels in reaction to the October 1987 market crash. Initial speculative margin for the S&P 500 future was approximately 15% at that time. Moreover, in the report, the SEC Chairman suggested that, aside from prudential considerations, margins on futures and options should be raised to reduce market volatility. Working Group Report at 6.

[26] Intermarket frontrunning is trading in one market to take advantage of material, non-public information concerning an imminent transaction in a related market. For example, frontrunning could involve, among other things, the execution of a stock index futures transaction by a broker-dealer on the basis of a large customer stock program order possessed by the broker-dealer.

Common sense may be a useful tool in analyzing this problem. Traffic control on a highway could not be expected to work effectively if northbound lanes were under one set of rules and enforcement, while southbound lanes came under different laws and a different highway patrol. Air traffic control would not be very effective if one set of controllers in one tower had authority over planes taking off from an airport, while a different set of controllers in a different tower, using different equipment and procedures, had authority over planes that were landing. This bifurcated enforcement problem is significant because equities and equity index futures are essentially fungible products -- closely related if not identical.

Coordinated regulatory action can partially mitigate this problem. For example, the New York Stock Exchange ("NYSE") and the CME have agreed upon and adopted a uniform policy that defines intermarket frontrunning and prohibits members of the two exchanges from engaging in such activity.[27] Under the policy, members who engage in transactions in a stock index future or an option on such a future in order to take advantage of the imminent execution of another person's stock program transaction, or vice versa, may violate "just and equitable principles of trade" and become subject to sanctions. This policy does not, however, prevent a member from establishing a bona fide hedge position or from implementing a legitimate proprietary trading strategy.

Compared with regulation by a single agency, coordinated regulation remains inefficient and often ineffective. While we applaud the efforts of the NYSE and the CME, fully seven years had passed from the commencement of trading of the S&P 500 stock index future on the CME until the agreement was signed. Moreover, even today, the CME does not share surveillance information with the NYSE on as liberal a basis as do options and other securities exchanges.

Even worse, there remain gaps in intermarket cooperation. The NYSE and the CBT have still not been able to reach a surveillance sharing agreement, although we understand that the two exchanges are attempting to reach one.[28] A single agency such as the SEC with oversight over both the NYSE and CBT would have had the authority to cause an agreement on surveillance and enforcement to occur much sooner. Thus, the fragmentation of regulatory authority has reduced both the level of surveillance and the likelihood of effective enforcement action against frontrunning and manipulative activities.

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[27] See Securities Exchange Act Release No. 27047 (July 10, 1989), 54 FR 31131.

[28] We note that the CBT participated this past summer with the NYSE and the CME in a special review of potential index frontrunning.

D. Obstacles to International Coordination

The fragmentation of regulatory jurisdiction also impedes the Commission's efforts to respond to the globalization of the world's securities markets. The Commission is not aware of any other major industrialized country that separates regulatory authority over the stock markets from regulatory authority over the stock index futures markets. As a result of our bifurcated system, neither the SEC nor the CFTC can negotiate comprehensive agreements concerning the equity and equity derivative markets with our regulatory counterparts from other countries.

Instead, international negotiations must be coordinated or conducted in separate stages, a process that over time will most likely hamper the United States from striking the best possible agreements for its markets as a whole. Moreover, the ability of each agency to speak authoritatively and to represent the interests of the U.S. financial markets in international discussions is adversely impacted by its limited jurisdiction. This cumbersome process does not represent a sensible allocation of resources, and it reduces the ability of the U.S. negotiators to maximize overall U.S. interests in designing global regulatory principles.

E. Protection of Clearance and Settlement Systems

The existence of dual regulatory structures also has impacted efforts to reduce payment system pressures through the development of cross-margining programs, which have been proposed to reduce unnecessary demand for liquidity during times of market stress.[29] The SEC, the General Accounting Office, and many market professionals who participate in these markets have all agreed with that proposal.

Pilot cross-margining programs for proprietary accounts have been approved by the SEC and the CFTC.[30] As a result, during the market decline that began on October 13, 1989, two major pilot participants were able to reduce their margin payment obligations by approximately $150 million. In part because of the jurisdictional split, these programs have not been expanded. For example, many options marketmakers are extremely active in the stock index futures market for hedging purposes, yet the pilot programs have not been extended to include marketmaker accounts because of CFTC interpretations as to the applicability of their customer segregation requirements to those accounts.

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[29] See Brady Report at 64-66.

[30] The SEC approved an Options Clearing Corporation ("OCC") proposal to provide for cross-margining of OCC-cleared securities options with futures positions cleared by the Intermarket Clearing Corporation ("ICC"). See Securities Exchange Act Release No. 26153 (October 3, 1988), 53 FR 39569. The CFTC also approved a corresponding ICC rule change. See letter from Jean A. Webb, Secretary, CFTC, to George S. Hender, President, ICC, dated June 1, 1988.

F. Efficient Use of Resources

The failure to establish a coordinated regulatory regime has led to a waste of resources by the regulators and the regulated alike. As a result of the bifurcated regulatory system, broker-dealers and futures commission merchants must answer to two regulators, even when they are part of the same organization and are working for the same investors. They must register personnel with two different agencies and create separate compliance programs. These costs are, in large part, redundant.

In addition, the need for compliance with the sometimes divergent requirements of the SEC and the CFTC can interfere with the efficient provision of services to investors. For example, a firm that is qualified to trade stock index options, but not stock index futures, cannot advise a client effectively about the relative benefits of the alternative investments. A firm that is qualified only to trade futures has no capability to advise clients with respect to stock or option alternatives. As a result, the artificial distinctions between regulation of the stock and stock index futures markets increase the industry's costs while reducing its ability to respond to investor needs.

The fragmentation of regulatory responsibility between two agencies has also resulted in increased costs to the federal government, and thus to the U.S. taxpayer. Efforts to identify the exact contours of the boundary between the SEC and CFTC have consumed resources that should go into regulatory programs. Furthermore, because two agencies must do the work that could otherwise be done by one, the two agencies have developed duplicative expertise and systems to monitor the equities markets. Both agencies maintain regional offices in Chicago, New York and Los Angeles. Administrative functions -- personnel, budget and similar functions -- are also duplicative. In addition, the SEC and the CFTC must compete for talented and experienced staff members. The inevitable result is less effective and more expensive regulation. While the SEC collects industry fees well in excess of its annual budget, the CFTC is at present almost entirely funded by the taxpayers -- not the futures industry. Thus, the futures industry has little incentive to curtail duplication and expense. Instead, it actively opposes the President's proposal that it should at least pay the regulatory costs currently borne by the taxpayers.

V. POSSIBLE SOLUTIONS TO THE PROBLEMS CAUSED BY FRAGMENTED REGULATORY JURISDICTION

It is apparent that the fragmentation of regulatory jurisdiction over the stock and the stock index futures markets has caused, and will continue to cause, serious problems for the United States securities markets from the standpoint of market integrity and international competitiveness.

Our two agencies have worked together cooperatively in the past, and we will no doubt do so in the future. Unfortunately, the problems created by the interconnection between the stock and stock index futures markets cannot be solved by cooperation alone, and they are likely to get worse. These threats can be avoided, and they can be avoided without harm to the legitimate competitive concerns of both the securities and futures industries.[31]

A. Margin

Congress should act swiftly to reform the system of margin regulation to reduce the disparities in levels of permissible leverage among all equity products -- stock, stock options, and stock index futures.

In order to address this problem, the Commission believes that Congress should establish a framework for federal regulation of margin on stock index futures contracts. Margin on futures contracts simply should not be completely exempt from regulatory oversight. Congress has wisely determined that there is a broad public interest in margin levels in the stock market; the public interest in margin levels in the stock index futures market is no less compelling.

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[31] Commissioner Fleischman concurs in the recommendation in Part V.B. concerning modification of the exclusivity provisions of the CEA. As to reform of margin regulation, Commissioner Fleischman remains convinced of the soundness of the legislative proposal submitted unanimously by the Commission to the President of the Senate on July 6, 1988, and therefore disagrees with the recommendations in Part V.A. As to jurisdictional change, Commissioner Fleischman notes his agreement with Commissioner Schapiro that, of the alternatives presented in Part V.C., the best alternative for the economy as a whole and for the futures markets in particular would be a merger of the SEC and the CFTC. Nevertheless, on the basis of his understanding of principles of financial regulation articulated in the Report of the Task Group on Regulation of Financial Services (July 1984), Commissioner Fleischman dissents from the positions expressed in Part V.C. and the related preceding analysis.

There are two relatively easy and positive means to redress the margin problem. First, Congress could simply provide the Federal Reserve Board ("FRB"), which already has margin authority over stocks, with the power to set margins on stock index futures. The Commission would support this change. Alternatively -- and less preferable -- both stock and stock index futures margin authority could be transferred to the SEC, perhaps in consultation with the FRB.

Second, if establishing a single agency to set margins, as originally suggested by the Brady Commission, proved impracticable, Congress could also set a statutory minimum level for all margins, with the SEC and CFTC having authority to lower the minimum level by mutual agreement. A minimum margin level would help ensure that, with interconnected equity and derivative markets, a single market does not become excessively leveraged to the detriment of the entire financial system.

We note that Secretary Brady has also expressed concern over the effect that low futures margin may have on the stock market. This issue has been discussed as part of the deliberations of the President's Working Group on Financial Markets (the "Working Group").[32] We believe that harmonization of stock and futures margin requirements (either through a single authority to set margins or a legislated minimum level -- a "national speed limit" -- on margins) is the appropriate result for the Working Group process.

The third alternative for solving the margin issue is not, in my judgment, the way to solve this problem. But if Congress reaches the de facto judgment that margins on the S&P 500 futures contract should be exempt from all federal regulation, then Congress should consider whether margin on the S&P 500 stocks themselves should also be reduced below the 50% level, at least for suitable investors, or turned over to the securities SROs. Wholly arbitrary differences in government margin rules should not be allowed to drive capital out of the equity markets and into the futures markets. Competition between Chicago and New York is perfectly fine, but that competition should not be based on artificial regulatory differences.

B. Exclusivity

In addition, Congress should take steps to modify the exclusivity provision of the CEA. As described above, absent Congressional action to modify the exclusivity clause, the development of new securities products will be severely curtailed or forced offshore. To resolve this situation, it is essential that Congress repeal the exclusivity clause in its entirety or limit its application to products that are not regulated by the SEC, FRB, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation or Office of Thrift Supervision. It is not sufficient to ask whether the current system promotes strong futures markets. We must ask whether the anticompetitive exclusivity provision promotes a strong U.S. financial system and a competitive economy. The answer to that question is clearly negative.

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[32] Letter from Nicholas F. Brady, Secretary, United States Treasury, to Christopher J. Dodd, Chairman, Subcommittee on Securities, U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 2, 1990).

The Commission believes that legislation is urgently needed to address the anti-competitive effects of the CEA's exclusivity provision. The U.S. markets cannot remain competitive if useful, fully regulated products that are desired by investors cannot be traded because of arbitrary jurisdictional boundaries. U.S. markets and broker-dealers should not be put in the position of designing products to fit regulatory pigeonholes; rather, they should be encouraged to continue to create products that meet investors' needs. To foster that creativity, the regulatory system must be able to respond flexibly to ensure that, consistent with the protection of investors and the integrity of the market, such products can be brought to market with as few regulatory impediments as possible.

At a minimum, therefore, the CEA's exclusivity clause should be modified so that products that are subject to the regulatory jurisdiction of another federal financial regulatory agency are not prohibited simply because they are not traded on a futures market. Jurisdictional uncertainty cannot be allowed to destroy the creative energy that is one of the greatest strengths of the U.S. markets. Congress, rather than the CFTC or any other single agency, should decide when and how to alter the complex regulatory systems that exist in banking, insurance and securities. The general approach of "functional regulation" would serve us well in this case. Until there is centralization of the agencies themselves, the respective line regulators should decide what is a security or a banking product, rather than allowing the CFTC to be the arbiter of the system by regulatory fiat.

C. Jurisdictional Change

Focusing on intermarket issues as they arise will not solve the fundamental problem that different aspects of a single market are regulated by different agencies. No matter where the line is drawn, if there is a jurisdictional boundary between the two agencies, market participants will test the edges of that boundary, and there will be continual debate over where the line should be drawn. As a result, if Congress chooses to take a "piecemeal" approach to the questions raised by fragmented regulation, it will be called on again and again over the years to plug holes in the regulatory dike. "Better communication" is not the answer, for our problem is not that we do not know the views of the other agency. The problem is that nobody is able to resolve disputes over the best means of promoting the overall national interest.

If we are to eliminate these problems once and for all, we should focus not on symptoms, but on the basic problem of an artificially bifurcated regulatory structure under which one market is regulated as if it were two. Smaller, easier fixes may be simpler in the short run, but they will be prohibitively expensive, in terms of U.S. competitiveness and the stability of the financial system, in the long run.

Critics of jurisdictional change have attempted to create theoretical obstacles to transfers of regulatory jurisdiction. For example, some suggest that there is a logical consistency to the current division of regulatory responsibility between the two agencies, since the SEC regulates capital-raising activities (such as the stock market), while the CFTC regulates risk-shifting vehicles.

The assumptions underlying this argument are incorrect. In the first place, options, like futures, are risk-shifting vehicles, and the market for options, like the futures markets, is in "zero net supply." Although some allege that the Commission has a bias in favor of rising markets, the SEC has regulated the options market effectively for many years, and it will continue to do so far into the future. These markets have developed a wide variety of new products. Where not defeated by jurisdictional restrictions, the SEC has moved quickly to approve their trading, with appropriate regulatory protections.

Furthermore, the SEC already administers a variety of statutes with different purposes and disparate levels of regulatory authority, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. Thus, the SEC has already demonstrated that it can regulate a broad spectrum of statutory schemes and a broad range of instruments effectively, without favoring one group or one instrument over another. We could certainly administer the CEA smoothly and effectively, either in total or only as it applies to financial instruments or stock index futures.

Even if the distinction between capital formation and risk shifting were valid for some instruments, it certainly is not valid for all. New financial instruments may incorporate elements of both capital raising and risk shifting. For example, currency-linked debt is ordinarily sold by an issuer to raise capital, but may be purchased by an investor for hedging purposes. These instruments cannot easily be categorized as either capital-raising or risk-shifting vehicles.

Some defenders of the current regulatory environment also have argued that division of regulatory authority leads to competition among regulators and that this competition improves the efficiency of regulation. They claim that the existence of alternative regulatory structures will allow market participants to choose the regulatory environment best suited to their needs, and thereby will produce the optimal level of regulation. Without this regulatory competition, they claim, innovation will be stifled. While experimentation *is* beneficial, its costs will outweigh its benefits if a "race to the bottom" in permissible levels of leverage or standards of conduct is allowed to develop.

It is also important to note that the theoretical benefits obtained through regulatory competition are available only if market participants have the ability to choose between competing regulatory regimes. In the United States today, however, market participants cannot choose between securities and futures regulation, because the exclusivity provision of the CEA prevents them from doing so.

Many of the supposed benefits of competition between *agencies* can be achieved through competition among *markets*. For example, whether or not the equities markets are regulated by one agency or two, the NASDAQ and Amex will still be in competition with the NYSE, and the NYSE will still be in competition with the CME. The SEC is required by law to encourage such competition among regulated entities. Competitive pressure can improve the capabilities of the markets and can encourage the development of innovative products.

In today's global financial markets, investment dollars can flow relatively freely from the United States to foreign markets. To the extent that another country provides a more attractive regulatory environment, U.S. investors are free to invest in that market. Therefore, multiple domestic regulatory alternatives are less necessary than they may once have been as a device to prevent overregulation. Today, foreign competition provides an even more potent limitation on overregulation. Indeed, it is in large part *because* of the threat of global competition that we must consider streamlining our current regulatory structure.

The currently fragmented regulatory structure for the stock and stock index futures markets can be reformed in a number of different ways. Each of these will require combining certain regulatory functions that currently are carried on by two agencies into a single regulator.

The most comprehensive solution to the problem of regulatory fragmentation would be to combine oversight of all securities, options, and futures activities within a single agency. This solution has been advocated by SEC Commissioner Mary Schapiro, a former senior staff member of the CFTC and General Counsel of the Futures Industry Association. Commissioner Schapiro believes that the best of the options presented, for the economy as a whole and for the futures markets in particular, would be a merger of the SEC and the CFTC.

An agency merger would allow the two agencies to reduce duplicative support staff and administrative costs. A merger would also facilitate the development of harmonized registration and regulatory requirements, which would substantially reduce the compliance costs of broker-dealers and futures commission merchants, and give professionals wider access to securities, options and futures markets. In addition, merger of the agencies would bring both the securities and the futures markets under a single regulator, thereby providing a more efficient mechanism for resolution of intermarket jurisdictional disputes in the future. Finally, as we learned in the recent Drexel matter, failing firms will be active in both financial and non-financial futures markets and the ability of one regulator with a comprehensive view of the financial health of a firm to monitor and assist in the transfer and reduction of positions would be very beneficial.

A merger of the two agencies need not disrupt the basic statutory structure under which the securities and futures markets operate. Assuming appropriate statutory changes to address the margin and exclusivity issues discussed above, all futures products could continue to be traded pursuant to the CEA and under a single regulator, subject to the same Congressional oversight that exists today.

A second alternative would be for Congress to restructure the futures markets by assigning the regulation of all futures on financial instruments to the SEC, with the CFTC retaining jurisdiction over all futures on agricultural or physical commodities.

Finally, as a third alternative, Congress could consolidate the regulation of the stock and stock index futures markets within the SEC. While it is the "narrowest" step, this move would nonetheless address some of the most pressing problems of the current structure.

Despite the potential benefits of an agency merger, many futures market participants appear to fear that the SEC's hand on the tiller might be adverse to their future course. A full merger, while perhaps the simplest resolution of this issue, is not necessary to solve the worst problems described herein. At a minimum, these problems could be effectively addressed by a three point program of (1) transferring regulation of stock index futures to the SEC, (2) harmonizing margin systems as described above and (3) eliminating the exclusivity clause.

These minimum steps would strongly benefit the public and both equity and equity derivative markets by promoting competition within a framework designed to maximize stability of our overall market and to minimize the chances for either systemic crisis or intermarket fraud and manipulation. At the same time, the SEC would work hard to ensure that the nation's equity index futures markets remained strong and competitive.

VI. CONCLUSION

The fragmentation of regulatory responsibility over the equities markets has had serious consequences for those markets. The current system is not fully effective in maintaining the stability of the nation's financial markets or in detecting and enforcing sanctions against violations of federal law as a result of intermarket activities. Furthermore, the existing system restrains competition between securities and futures markets and seriously impedes the development and marketing of innovative financial products, thereby undermining national competitiveness. As a result, the present system does not promote the long-term public interest in stable, efficient and competitive markets.

Over the past few months, the Commission has worked closely with the members of the Working Group to discuss the problems resulting from fragmented regulation. As part of these discussions the members of the Working Group have considered whether a restructuring of the present regulatory system is warranted. As a member of the Working Group, I strongly believe that either an agency merger or the three point proposal described herein would benefit the overall public interest.

Whether or not Congress determines to address issues of jurisdictional structure, however, the Commission believes that Congress should take swift action to cure two glaring problems -- margin on stock index futures and the CEA exclusivity clause -- that have arisen as a consequence of the fragmented regulatory environment. These matters have risen to crisis proportions, and must be addressed if Congress wishes to maintain a strong securities industry and investor confidence and participation in those markets.

If we cannot agree to take effective action against these problems, significant harm will result for the securities industry, in which the United States is strongly competitive globally. Significant systemic risks that are completely avoidable will continue, with an unknown probability of serious cost and damage to the overall economy and the public. On the other hand, if we begin to reform the system, at least with respect to margins and exclusivity, we will have taken a major step to rationalize an overly-cumbersome system. In this way we can demonstrate that the United States is willing to modernize our overall system to promote both safety and competitiveness.

Senator **Dodd**. Thank you very much, Chairman Breeden.

Dr. Gramm, thank you for being with us.

STATEMENT OF WENDY GRAMM, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Dr. **Gramm**. Thank you, Mr. Chairman, I welcome the opportunity to be here today to present the views of the Commodity Futures Trading Commission on financial regulation and jurisdictional issues.

U.S. financial markets must remain strong and competitive, and it is our job as policymakers to ensure fair and open markets, financial integrity, investor confidence and international competitiveness for all U.S. markets, both securities and futures.

Let me turn directly to the issue before us today.

Should we redraw the boundaries separating the jurisdiction of the Commodity Futures Trading Commission and the Securities and Exchange Commission?

Three alternatives concerning jurisdiction have been publicly discussed: shift stock index futures jurisdiction from the CFTC to the SEC; shift jurisdiction over all financial futures to the SEC, or merge the two agencies.

This is a radical restructuring of our jurisdiction. The fundamental questions that would ordinarily precede such a restructuring have not been answered: What needs to be fixed? How will a shift in jurisdiction fix the problem? What policies would be altered and how, specifically? What are the possible unintended consequences of a jurisdictional shift?

The Commodity Futures Trading Commission opposes any shift in CFTC jurisdiction. We believe such a shift will not solve the real issues that face our markets today. Those issues are not the ones you see most frequently in the media.

Some of the real issues that do need to be addressed include the long-term decline in retail securities brokerage business, short-term stock market volatility and intermarket issues like systemic risk and clearing settlement and payments.

These issues do not exist because of the current regulatory boundaries nor will a change in jurisdiction resolve the dilemmas. To suggest that a quick fix regulatory shift will solve these problems does not withstand careful scrutiny and could raise false hopes.

Are there any credible arguments for shifting CFTC jurisdiction to the SEC or for merging the two agencies?

Recently we have been told a handful of so-called "problems" that exist. We are also told that a quick fix jurisdictional change is the miraculous wonder cure that will solve them all.

My prepared statement includes a point-by-point factual analysis of these problems. If you wish, I would also be happy to provide for the record studies and analyses that form the bases of our views, but let me just touch on a few issues now.

The securities market and the stock index futures markets are indeed one market. That is no surprise to CFTC. Every futures market is closely linked to its underlying cash market. That does not mean, however, that these linked markets must be subject to a single regulator with a single rule book. In fact, merging the cash market regulator, which tends to favor stable or higher prices, and the futures regulator which must remain priceneutral, would institutionalize the very kind of regulatory conflict of interest Congress sought to avoid in creating the independent CFTC in 1974.

Stock index futures have not driven individual investors out of the stock market. Direct stock market participation by individuals has, indeed, declined, but not because of stock index futures. The decline has been going on for decades and is transforming the financial service industry around the world. The individual investor is still in the market participating through institutions such as pension funds and mutual funds. And the risk associated with investor positions is frequently managed by these institutions with futures contracts.

Stock index futures don't cause volatility any more than puddles cause rainstorms. Causality runs the other way. Volatility gives rise to the need for futures trading. But that doesn't mean we shouldn't work to try and understand whether or not there are volatility problems in the stock market.

Nor do any of the arguments that try to link futures margins with stock market volatility really stand up to factual analysis at this point. The Working Group on Financial Markets less than 2 years ago unanimously agreed that for prudential purposes stock margins must be significantly higher than futures margins to provide the same level of financial protection. The proof that the futures margining system works well is unequivocal. No clearing member firm defaulted in either October 1987 or October 1989.

Despite allegations, there is no concrete evidence yet that intermarket front running or any other intermarket trading abuse pose a significant threat to market integrity. That is not to say that we and the exchanges, along with the SEC, aren't working or haven't made progress in this area. Potential abuses are being addressed through coordinated monitoring and enforcement efforts within the existing regulatory structure.

As to the argument about the existence of two regulatory agencies hindering the United States in international negotiations, I would again respond that the evidence speaks for itself. To my knowledge, neither the SEC nor the CFTC has been impeded in its dealings with foreign regulatory authorities. On the contrary, both agencies have memoranda of understanding with foreign jurisdictions concerning information sharing and regulatory cooperation. In fact, CFTC has led the way in developing information sharing agreements for routine sharing of financial information of participants.

Finally, I must say that the most surprising argument now being made is that the CFTC and the futures industry stifle innovation. Anyone who would take the time to review the record will find that innovation is embedded in the fabric of the industry and that the commission acts to encourage it.

I dare say there are few industries in the United States today that have grown as fast as the futures industry from 1974 to the present. This impressive growth of new products and also whole new trading systems could not have occurred in an atmosphere that stifled creative thinking and frowned upon new ideas. While encouraging innovation, the commission has continued to ensure that statutory goals are met.

Briefly stated, the commission believes that the case for shifting jurisdiction over stock index futures to the SEC or for merging the two agencies simply has not been made. Stock index futures serve important economic functions—price discovery and hedging—the same functions performed by all the futures contracts that the commission has approved.

The commission believes that margins on futures contracts should be set for the prudential purpose of assuring contract performance rather than being used in a futile and costly attempt to control market volatility.

The commission believes that the same agency that regulates all other futures contracts should continue to regulate stock index futures. Stock index futures, too, require regulation by an experienced and expert agency, but most importantly, by a price-neutral agency sensitive to the hedging and risk-management function of these markets.

Under the existing regulatory structure, the United States has the oldest, most liquid, most innovative and largest futures markets in the world. Today these markets serve as models for other countries which are developing futures and options products just as regulatory system in place at the CFTC serves as a model for other countries as they develop their own futures market regulatory systems. We should do nothing that would jeopardize this success.

Thank you very much.

[The complete prepared statement of Wendy L. Gramm follows:]

Statement of
Dr. Wendy L. Gramm
Chairman
Commodity Futures Trading Commission
Before the
Securities Subcommittee of the
Senate Committee on Banking, Housing,
and Urban Affairs
March 29, 1990

Mr. Chairman, I welcome this opportunity to appear before this Subcommittee to present the views of the Commodity Futures Trading Commission (CFTC) regarding financial regulation and jurisdictional issues. United States financial markets must remain strong and competitive. Those of us charged with making policy choices must strive to maintain fair and open markets, financial integrity, investor confidence and international competitiveness for all United States markets -- both securities and futures. As we address these issues, we must be careful to distinguish fact from rhetoric, the legitimate goal of international competitiveness for all United States markets from the claims of competing domestic market interests, and the different functions served by capital formation and risk-shifting markets. Therefore, we must address the real issues the markets face in meeting the economic needs of market participants, in maintaining customer confidence, and in meeting the competitive challenge from abroad.

The CFTC and United States futures markets have met this challenge well. The markets have been, and continue to be, one of America's most innovative and competitive industries. Under the existing regulatory scheme, the United States has the oldest, most liquid, most innovative and largest futures market in the world. United States futures markets permit commercial institutions, firms, institutional investors, and fund managers to manage risk associated with changing cash market prices. In 1960, 3.9 million futures contracts were traded. Last year, over 267 million contracts traded. Since 1984, all futures volume has grown by 79 percent and in that period financial futures -- interest rate, stock index and foreign currency contracts -- have grown from 49 percent to 61 percent of total volume. Today, United States futures markets serve as models for other countries developing futures and options products, just as the regulatory system at the CFTC serves as a model for other countries developing futures market regulatory systems.

Let me turn to the issue before us today -- whether to redraw the boundary separating the jurisdictions of the Commodity Futures Trading Commission and the Securities and Exchange

Commission (SEC). There are three alternatives regarding jurisdiction that have been publicly discussed: 1) shift stock index futures jurisdiction from the CFTC to the SEC; 2) shift jurisdiction over all financial futures to the SEC; and 3) merge the SEC and the CFTC. Each of these alternatives would result in a radical restructuring of current regulatory systems. Yet fundamental questions, that would ordinarily precede such a radical restructuring, have not been asked nor answered. These questions include:

- What problem is the proposed shift in jurisdiction supposed to fix?
- What would such a shift in jurisdiction accomplish?
- What specific policies will be altered as a result of a change in jurisdiction? In other words, what would be done differently? And how?
- What are the possible unintended consequences of a jurisdictional restructuring?

The Commodity Futures Trading Commission opposes any change in CFTC jurisdiction, including a shift of jurisdiction for stock index futures, or financial futures, or a merger of the SEC and the CFTC. The Commission does not believe a change in CFTC jurisdiction will solve any of the real issues our markets face today. To be sure, there are some important issues facing financial markets and their regulators -- long-term decline in retail securities brokerage business, long-term decline of United States prominence in world equity markets, short-term stock market volatility, and intermarket issues such as systemic risk in clearing, settlement, and payments. These issues do not exist because of current jurisdictional boundaries between the CFTC and the SEC -- nor will a change in jurisdiction resolve these dilemmas.

Are there any credible arguments for shifting CFTC jurisdiction to the SEC or for merging the two agencies? Recently, we have been told a handful of so-called problems exists. Without verification or analysis of these problems, their causes or various solutions, we are told that a change in the jurisdiction of the CFTC is in order.

To suggest that these so-called problems will be solved by a quick-fix jurisdictional shift does not withstand scrutiny. It is important that the Committee not be misled. Facts, not assertions, are necessary to distinguish between true market reform and regulatory imperialism.

One argument made for changing CFTC jurisdiction is that the stock index futures market and the stock market are really one market and therefore, require one regulator.

Those who understand futures markets have long been aware that every futures market for every commodity is linked to the underlying cash market. But each futures market serves a different purpose from its underlying cash market. The fact that these markets are linked or interrelated does not mean that their separate components serve a single purpose or require a single regulator. Nor does it mean that their separate components can operate safely or successfully under the same rules.

Well over a century ago, American farmers discovered that futures and cash markets were linked and that this linkage allowed them to use futures markets to hedge price risk and lock in the price of grain in the months ahead. Today, the CFTC regulates more than 80 derivative contracts ranging from wheat to oil to Treasury bonds to stock indexes. Although the pricing structure, delivery mechanisms and other economic fundamentals in each of the underlying cash markets vary widely, they are each linked to their futures contract, and the futures contracts are all traded and regulated in the same way.

Although futures and cash markets are linked, it does not follow logically, nor is it a matter of good policy, to insist that cash and futures markets be regulated in the same way or by the same regulator. In fact, in 1974 Congress reached precisely this conclusion and severed futures regulation from cash market regulation. When Congress established CFTC as an independent agency separate from the cash market regulator, it recognized not only the functional differences between the cash and futures markets, but also acknowledged the potential conflicts of interest that could arise when the futures and cash markets are regulated vertically (by product line), rather than horizontally (by function across commodity groups). As the General Accounting Office observed in 1974 at the time futures regulation was shifted from the Department of Agriculture to the new CFTC:

> A potential conflict of duties and responsibilities might exist if the Commission were located within the Department of Agriculture, and chaired, on a permanent basis, by the Secretary of Agriculture, who is charged by law to influence and maintain the prices of many of the commodities traded in the futures markets. (H.R. Rep. No. 93-975 at 60).

The perceived policy goals of the USDA for stable or higher agricultural cash commodity prices may be no different from the SEC's interest in stable or higher stock prices. However, in order to have an effective futures market, the futures regulator must be insulated from any such price bias in order to maintain price neutrality.

Even if there were one market regulator, functional differences would have to be recognized for successful regulation. The Commodity Exchange Act reflects the special risk-shifting functions of futures transactions and provides market and customer protections distinct from those applicable to securities and other cash markets.

Perhaps most notably, the contract market designation requirements that must be satisfied before a futures contract may be approved for trading have no counterpart in the securities laws and reflect the special functions of futures transactions. Section 5(g) of the Commodity Exchange Act requires that an exchange seeking designation as a contract market demonstrate "that transactions for future delivery in the commodity for which designation as a contract market is sought will not be contrary to the public interest." This "public interest" standard incorporates a requirement that a proposed futures contract be shown to be likely to serve an "economic purpose" consisting of a price basing or hedging use on more than an occasional basis, as opposed to predominately speculative purposes. Pursuant to Section 5(g), the Commission reviews each proposed futures contract to determine whether the applicant exchange has adequately demonstrated that the proposed contract serves an economic purpose, has addressed the possible susceptibility of the contract to manipulation by justifying its individual terms and conditions, and that other relevant public interest concerns have been satisfied.

In addition, the Commodity Exchange Act includes requirements for segregation of futures customer funds; establishes authority for the Commission to establish a "large trader" reporting system; provides the Commission authority to impose speculative position limits; and establishes a customer reparations forum at the Commission. These provisions lack counterparts in the securities laws.

Other arguments put forth to justify a shift in CFTC's jurisdiction imply certain failures in the current regulatory system; however, none of these failures is explained. These claims state: —

- Stock index futures and related trading strategies have driven the individual investor from the stock market and impaired its capital raising function.
- Trading stock index futures causes increased stock market volatility.
- Margins on stock index futures are too low and are inconsistent with cash market margins. As a result, market volatility is increased and market declines are exacerbated.
- Separate regulators can not effectively police intermarket frontrunning.
- The existence of two agencies in the United States to regulate securities and futures markets puts us at a disadvantage in international negotiations with the regulators from other major countries, all of whom have a unified system of regulation.
- The futures industry and the CFTC stifle innovation, most recently preventing index participation units (IPs) from trading in the United States.

Let's examine each of these claims and consider the facts. Are these so-called problems caused by current jurisdictional boundaries between the CFTC and the SEC? Does the regulatory "wonder-cure," reducing the CFTC's jurisdiction by increasing that of the SEC, solve the problem? Are there any side effects to this proposed financial market "wonder-cure?"

The Individual Investor. Has the individual investor been driven from the stock market? If so, why?

The evidence is clear. Stock index futures are not driving the individual investor from the stock market. Direct participation in the stock market by individuals is indeed declining, but not because of stock index futures. This decline has been going on for decades and is transforming the financial service industry around the world. It was in the 1960s and 1970s that households shifted their asset holdings away from direct equity investments. For example, in 1968 households held 33 percent of their assets directly in stocks; by 1974 they held only 15 percent of their assets directly in stocks, and that fraction has been roughly constant for the last 15 years. The retreat, then, occurred well before stock index futures and program trading appeared on the scene.

The flip-side of the trend away from direct household investment in the stock market is, of course, the long-term increase in equity holdings by pension funds and other institutional investors. The inevitable consequence of this shift in holdings from households to institutions is a shift in trading methods. Retail trading has declined dramatically just as block trading and other trading strategies have become more prevalent.

The truth, then, is that many individual investors shifted their equity investments towards indirect holdings and away from direct holdings. Simply put, the individual investor is still in the market but now he participates through institutions such as pension funds and mutual funds. And the risk associated with his or her positions are managed effectively through the use of futures contracts.

Given these facts, it is hard to imagine how a shift in CFTC jurisdiction could reverse this trend toward investor participation in the stock market through institutions.

Stock Index Futures and Volatility. Do stock index futures cause stock market volatility?

There is no credible evidence that supports the contention that futures trading contributes to excessive volatility in the cash market. More volatile cash markets tend to have more active futures markets -- that is because cash market volatility increases the desirability of taking futures positions, not the other way around. The overwhelming consensus of a vast number of academic studies on this issue concludes that futures trading does not contribute to cash market volatility.[1] In fact there is an emerging consensus that cash market volatility has actually decreased upon the introduction of futures.

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[1] Clifford Smith and Charles Smithson, "Derivatives and Volatility," Intermarket, 1989.

Futures markets are successful only for products where there is a need to protect against price risk. Futures do not eliminate volatility but make it more manageable. That is, volatility in the cash market generates a desire for protection from the impact of price fluctuations. Such protection can be provided by futures markets, which lower the risk to market participants and encourage their participation in the cash market. Thus, futures contribute to the liquidity of the underlying cash market. This applies to all cash markets, including agricultural and financial markets.

Arbitrage between cash and futures markets keeps them linked. As for the argument that arbitrage between stock index futures and stocks contributes to market volatility, an SEC study of the October 1987 crash found that on October 19 the largest price decline occurred when index arbitrage volumes were at their lowest levels.[2]

How can a change in CFTC jurisdiction reduce or eliminate excessive stock market volatility? It cannot. A jurisdictional shift alone can do nothing to affect volatility. However, rule changes that would likely accompany such a shift could lead to unexpected consequences, perhaps even an increase in volatility.

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[2] U.S. Securities and Exchange Commission, Office of Economic Analysis, Program Trading and Price Movements Around the October 1987 Market Break (Washington, D.C.: 1989).

Margins and Volatility. Are stock index futures margins too low, thus increasing market volatility and exacerbating market declines?

There is no credible evidence to support the contention that low margins for stock index futures cause stock price volatility. Futures margins are used for different purposes than stock margins and are collected in different ways. Futures margins are good faith deposits -- performance bonds -- set and required by the exchanges and brokers from both buyers and sellers of futures contracts to insure their respective financial obligations are met. Stock margins are not a performance bond but rather are a downpayment that limits the maximum credit that can be extended. Since futures and securities margins serve different purposes, there is no reason why they should be set at the same levels.

Calls for "harmonization" of margins must recognize the fundamental difference between the futures and securities markets, and the different settlement cycles and components of margin. The Working Group on Financial Markets, less than two years ago, unanimously agreed that for prudential purposes, stock margins must be significantly higher than futures margins to provide the same level of financial protection.[3] In fact, stock margins generally should be several times greater than futures margins for consistency. Chairman Greenspan put it succinctly less than two years ago in testimony before Congress:[4]

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[3] Interim Report of The Working Group on Financial Markets, (Washington D.C.: Government Printing Office, 1988), 2.

> Achieving consistency in margins for individual stocks and options and index-based products must take into account differences in price behavior of these instruments and differences in their settlement periods. Because all stock prices do not move in unison, values of broad portfolios of stocks are less volatile than prices of individual stocks and thus prudential margins on index futures do not need to be as high as those on individual shares. In addition, the longer is the settlement period, the larger is the potential cumulative price change and the greater is the risk exposure of the broker and clearinghouse. Futures contracts are cleared daily, and margin calls can be made several times a day, while the standard settlement period for shares is three days to a week. This consideration, too, would suggest a higher margin for individual stocks than for index futures (Greenspan, 1988).

The proof that the futures margining system works well is unequivocal. No clearing member firm defaulted in either October 1987 or October 1989.

Three arguments are made that claim that low futures margins, relative to stock margins, lead to excessive price volatility. The arguments are: (1) the high leverage due to low futures margins allows indirect, highly leveraged access to the stock market which leads to volatility; (2) the payments system is strained by demands for futures margin in times of extreme price fluctuations; and (3) margined futures traders are forced to sell to meet margin calls causing liquidity to vanish.

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[4] Statement by Chairman Alan Greenspan before House of Representatives, Agriculture Committee, June 14, 1988: 9.

(1) Leverage and volatility. Futures margin levels are established by reference to volatility. Past price volatility is used by futures exchanges to determine the probability of a one day price movement that would be sufficient to exhaust a customer's margin deposit. Futures exchanges raise margin during periods of expected high volatility. While critics undoubtedly accept the fact that higher volatility leads to higher margin, they also believe that low margins lead to higher volatility. At first glance any particular period of volatility can be interpreted to support either hypothesis: (a) margin was raised following the price break to cover the increased volatility; or (b) margin was relatively low prior to the price break, inviting the break.

Research on this question finds no significant evidence of an inverse relationship between margins and volatility. Examples of this research can be found in the work done by economists at the SEC and at the Federal Reserve Board.[5] Direct research on margin policy in stock index futures is limited because stock index futures contracts only began trading in 1982. The two extant studies directly on the topic, one by an SEC economist, and one by a Federal Reserve Board economist, did not find that low margins lead to high volatility. Paul Kupiec, at the Federal Reserve Board, concludes:

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[5] See Dean Furbush and Annette Poulsen, "Harmonizing Margins: The Regulation of Margin Levels in Stock Index Futures Markets," Cornell Law Review 74 (July 1989): 873; and Paul Kupiec, 1989, Federal Reserve Board, Washington, D.C.

> Although the degree of leverage available in index-futures products relative to the cash markets is often cited as prima facie evidence that futures markets are the conduit of speculation and excess volatility, there is little statistical evidence that supports this view. The evidence presented in this paper suggests that, if there exists a statistical relationship between the initial margin rate on stock-index futures products and the volatility in the cash market, the relationship is positive--that is, high margin rates in the futures markets tend to be associated with periods of above-average volatility in the cash markets (Kupiec, 1989).

Even the presumption that the futures market is a high leverage market is not supported by the evidence. Because of the different settlement periods, it is possible for there to be greater leverage for a player in the stock market than for one in the futures market. And, at times there is much greater opportunity for leverage in options on individual stocks than there is in the market for stock index futures. Moreover, according to a Stanford University economist, Jeffrey Williams, "[t]he salient feature of futures markets is precisely the frequency with which positions in futures contracts are combined with other positions."[6] This applies to stock index futures just as it does to agricultural, mineral, and other financial futures: in the S&P 500 stock index futures market two thirds of the open interest is held by commercials. A cash portfolio hedged with a futures position is not leveraged, regardless of the level of futures margins. Further, many large institutional participants such as pension funds are essentially unleveraged as a result of the requirements of their primary regulator.

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[6] Jeffrey Williams, The Economic Function of Futures Markets (New York: Cambridge University Press, 1986), 41.

In summary, there is no persuasive evidence that raising margins to equalize leverage would in fact reduce stock market volatility. We do know, however, that raising margins would raise costs and therefore, could reduce market liquidity in United States markets and force these products to trade overseas.

(2) The strained payment system. In 1988 the Working Group found margins were set at prudential levels. The futures markets already meet or exceed the recommendations to improve clearing and settlement systems made by the Group of Thirty for securities markets.

Moreover, many improvements suggested by the Working Group to the futures clearance and settlement systems have been made already or are underway. These improvements include the collection and payment of variation margin twice a day (at the Chicago Board of Trade Clearing Corporation and the Chicago Mercantile Exchange), thereby reducing calls for margin during non-banking hours; more sharing of information among futures and securities exchanges; and improved settlement agreements between futures clearing organizations and banks.

As long as settlements and payments continue to occur at different times for related positions there will continue to be systemic risk in the markets. Moreover, the potential systemic risk in the unregulated markets far exceeds the risk in the markets that are regulated. The CFTC and the SEC have a good working relationship in these areas, having worked together on a number of measures.

(3) Selling to meet margin calls. This argument contends that traders initially are attracted by low futures margins and that adverse price movements prompt margin calls which force selling that would not otherwise have occurred. This argument implies that traders must close their positions on volatile days to meet margin calls, prompting a decline in open interest for the futures contract as a whole and particularly for the affected group. An examination of the magnitude of open interest in the S&P 500 stock index futures contract on high volatility days contradicts the supposition that margin call sell-off exacerbated the market decline. On both October 19, 1987, and October 13, 1989, open interest at day's end was higher than on the previous day--more positions were opened than were closed (Table 1).

Table 1: Open interest prior to volatile trading days, S&P 500 stock index futures contract (October 19, 1987 and October 13, 1989).

Date	Open Interest	Percent Change	Date	Open Interest	Percent Change
10/12/87	123,064		10/06/89	122,284	
10/13/87	119,880	-2.59%	10/09/89	122,043	-0.20
10/14/87	127,582	6.42	10/10/89	122,394	0.29
10/15/87	133,696	4.79	10/11/89	124,625	1.82
10/16/87	146,653	9.69	10/12/89	124,361	-0.21
10/19/87	172,178	17.41	10/13/89	125,604	1.00

Furthermore, on October 13, only one of the 60 largest net position changes represented long liquidation by a speculator -- the speculator was a large commodity pool apparently responding to signals from a technical trading system, not to the variation margin call.

The majority of the Working Group on Financial Markets in its Interim Report in May 1988 correctly concluded that higher margins should not be used in an attempt to limit volatility.[7] Margins should be set for prudential purposes to ensure contract performance by limiting credit exposures of FCMs, brokers, banks, and, most importantly, clearinghouses. For prudential purposes, margins were adequate in 1987 according to the Working Group. Furthermore, on the issue of harmonizing margins on futures and stocks, the Working Group stated that stock margins must be significantly higher than futures margins to provide the same level of protection.

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[7] Interim Report, 6.

Is there a problem here that could be corrected by transferring CFTC jurisdiction to the SEC? The CFTC does not think so. Once again, the case has *not* been made that the existing system for margins has failed to do what it was designed to do or that a transfer of CFTC jurisdiction will solve any concern that has been raised.

Intermarket Frontrunning. Does the current regulatory structure permit intermarket manipulation?

Intermarket frontrunning has been described as trading in one market -- for example the stock market (or futures market) -- while in possession of material non-public information about orders or trades in another market -- the futures market (or stock market). Futures exchanges actively monitor trading patterns for intermarket frontrunning. Despite allegations, there is no concrete evidence that intermarket frontrunning or a other intermarket trading abuse poses a significant threat to market integrity. Any potential abuses are being addressed through cooperative and coordinated monitoring and enforcement efforts within the existing regulatory structure.

Prior to the October 19, 1987 market crash, all four futures exchanges that trade equity index contracts considered intermarket frontrunning to be a violation of their rules. Following the market crash, the Commission encouraged the futures exchanges to formalize their policies. By September 1, 1989, all four exchanges had put in place rules or interpretations on intermarket frontrunning. Notably, to date, the New York Stock Exchange is the only securities or option exchange that has an intermarket frontrunning "circular" (an official policy statement with the effect of a rule) in effect even though five securities exchanges trade stock index products. In fact the potential for abuse is great between equities and options markets, yet the Chicago Board Options Exchange (CBOE) has no rule.

The futures exchanges, with the encouragement and support of the CFTC, have discussed intermarket trading abuses with securities exchanges through the Intermarket Surveillance Group. As a result, the Chicago Mercantile Exchange and the New York Stock Exchange issued joint circulars and, on March 12, 1990 these exchanges began daily information sharing to monitor for potential abuse. The Chicago Board of Trade and the NYSE are currently negotiating a similar arrangement which is expected to be concluded very soon. Sharing market data allows the exchanges to perform regular, computer-assisted surveillance for intermarket frontrunning. Furthermore, the Chicago Mercantile Exchange, Chicago Board of Trade, and New York Stock Exchange are studying various days of trading during the summer and fall of 1989 for possible intermarket frontrunning abuses.

Thus far, all but one of the enforcement proceedings involving allegations of intermarket frontrunning have been brought by the Chicago Board Options Exchange and have involved allegations of frontrunning customer orders in specific securities by placing orders for the options on those securities. Two years ago, the American Stock Exchange (AMEX) brought an action involving a few days of trading its own Major Market Index options and NYSE-listed stocks in 1985. Since that time, neither the Commission, the SEC, nor any futures exchange or securities exchange has brought charges in the area of index-related intermarket frontrunning. Nor have any formal charges ever been brought alleging price manipulation in the futures or securities markets as a result of index-related intermarket frontrunning.

As the sophisticated information sharing and computerized analyses I have described generate evidence of potential violations, this situation may change. The enforcement divisions of the CFTC and SEC have an ongoing cooperative relationship in terms of sharing information and, indeed, have filed joint enforcement actions in other areas. We see no reason why this relationship will not continue regarding intermarket frontrunning and other types of intermarket abuses. As always, we at the CFTC stand ready to provide whatever assistance or information may be requested by the SEC to achieve effective law enforcement.

Again, it is difficult to imagine that a shift in CFTC's jurisdiction will facilitate the detection of intermarket abuse and enforcement of existing law. The SEC currently has full access to CFTC data and both agencies have full power to discipline market manipulators. There have been joint efforts when appropriate without inhibiting independent action as needed. All that is required is the willingness to cooperate.

International Regulation. Is the existence of two agencies in the United States to regulate futures and securities markets a disadvantage to the United States in international negotiations?

To the world at large, the CFTC and the SEC are regarded as the leading regulators of futures and securities markets, respectively. Witness the times the CFTC has hosted delegations of foreign regulatory authorities who have a desire to learn how the most successful futures markets in the world are regulated, or the number of commodity futures statutes in effect in foreign countries which are patterned on the United States Commodity Exchange Act.

In the area of international cooperation among regulators, neither agency has impeded the ability of the other to negotiate or otherwise deal with foreign regulatory authorities. For example, both agencies are joint parties with two United Kingdom governmental authorities in an information-sharing memorandum of understanding (MOU) to pursue futures and securities violations in the two jurisdictions, and the SEC has signed several additional MOUs with other foreign jurisdictions. Moreover, in connection with implementing its various international programs, the CFTC has been leading the way in developing information-sharing arrangements, particularly in the area of routine sharing of financial information.

Other countries that have only recently developed futures markets may have chosen a somewhat different way of organizing their internal regulatory structure. Our markets are the oldest, largest, most liquid, and most innovative. Since they have prospered and flourished under the current regulatory structure, I see no reason to change our system to parallel other foreign authorities. In fact, while some other countries' regulators may appear in their organizational charts to have only one agency in charge of securities and futures products, in practice bilateral negotiation often means working with several bureaus or divisions within the same governmental organization. In Japan, futures regulation is divided among three ministries, and financial futures are divided between the Securities Bureau and the Banking

Bureau in the Ministry of Finance. In the United Kingdom numerous regulatory and governmental authorities have jurisdiction over futures markets and transactions on those markets including the Department of Trade and Industry, Securities and Investments Board, and the Bank of England. International negotiation always means working with several representative agencies from the other countries, including from the United States. In agricultural trade matters, for instance, the Department of Agriculture, the United States Trade Representative, the Department of Commerce, and the Department of State all have an interest and expertise in such matters and are involved in negotiations.

Even if a change were called for, it is hard to imagine how an SEC dominated agency would be more effective at maintaining our competitive edge. Since 1975, United States equities have declined from 75 percent to only 25 percent of the world equity markets, while the futures market still boasts a world market share of 70 percent. It is interesting that the regulator whose industry has fared the worst internationally wants to take over the more successful industry in the name of international competitiveness. How would the recommended policy changes effect international competition? Raising margins on United States futures contracts will most certainly send business overseas, where margins are roughly equivalent to current United States futures margins.

Innovation. Do the CFTC and the futures industry stifle innovation?

The Commission's record on encouraging and accommodating innovation in financial products and trading systems is excellent. The United States futures industry has been the leading innovator of financial products, many of which it created within the past 15 years. In 1975, the CFTC approved futures contracts on GNMAs to trade on the Chicago Board of Trade, the first financial future. This was followed by futures contracts on commercial paper, Eurodollar rates, Treasury Bills, Treasury Notes, Treasury Bonds, Treasury Strips, Zero Coupon Treasury Bonds, and long-term Japanese Government Bonds -- to name just a few of the new interest rate contracts. After fifteen years of growth and development, financial futures and options have transformed the way institutions, including the United States Treasury, manage risk with significant benefits to the participants in these markets.

Currently, the futures exchanges are developing 24-hour trading systems, and most recently the CFTC approved the CME's Globex system -- an electronic futures and futures option trading network formed with Reuters Holdings PLC. In other areas of technology, futures exchanges have developed, and are continuing to develop, computerized reporting and market surveillance systems, to-the-minute audit trails, and hand-held "electronic trading cards." Each of these innovations has been developed by the futures industry under the oversight of the CFTC.

In addition to encouraging innovations in exchange-traded products, in 1987 the CFTC established a task force to review and accommodate, where possible, recent innovations in the area of off-exchange hybrid debt and depository instruments. Our goal was to allow innovation within the framework of the existing Commodity Exchange Act. And, we have succeeded in achieving this goal through rulemaking, statutory interpretation, a policy statement, and no-action letters. We worked with other agencies to avoid litigation, avoid regulatory gaps, and reduce regulatory uncertainty that existed in these markets -- uncertainties that stood as an impediment to further innovation.

It's important to realize that the changing structure of these markets will continue to challenge regulators and market participants in ways that will not make everyone happy. New instruments should and will continue to be developed -- instruments that seemingly cross jurisdictional lines and continue to challenge regulators as to what these instruments are and how they should be regulated. Therefore, it is likely there will always be some element of uncertainty. The only ways to guarantee complete regulatory certainty are to stop market innovation or have no regulation at all -- outcomes we all should truly regret.

Since the issue under discussion is shifting jurisdiction to the SEC, it is only appropriate to also examine the record of support for innovation at the SEC. If the CFTC had not been a separate independent agency during the past 15 years, would we have seen the growth in products that has made the United States the financial futures and options center of the world? It is doubtful. With respect to these financial instruments, the SEC has been less an innovator and more a roadblock.

In 1975, the SEC threatened to go to court to prevent the Chicago Board of Trade from launching its GNMA futures contract. In 1978, the SEC unsuccessfully sought from Congress the CFTC's financial futures jurisdiction. In the early 1980s, the SEC opposed the introduction of stock index futures because it believed they served "no economic purpose." But by 1982 the SEC was seeking jurisdiction over stock index options, and by 1988, jurisdiction over stock index futures.

Most recently, index participation products (IPs) have been called by some a market innovation that was stifled by the futures industry and the CFTC. Let us clear this up once and for all. The IPs issue has nothing to do with innovation. An IP is not some novel form of security. One can say a lot of things about an IP, but one thing it clearly has nothing to do with is capital formation. Nor are IPs some form of innovative hybrid. As the Seventh Circuit Court of Appeals decided on August 18, 1989, when it set aside an SEC order authorizing the trading of IPs on securities exchanges, IPs are simply futures contracts which by law must be approved by the CFTC in order to trade.

The litigation fostered by the IPs issue is not the way to deal with intergovernmental regulatory issues. A better model is to work to see if the desires of an exchange to trade a product, as well as the law and regulatory concerns, can be accommodated. In this regard, you should also be aware of the effort the Commission made to allow IPs to trade. Staff from the Commission and SEC met on numerous occasions to try to resolve the regulatory and jurisdictional issues. The Commission offered to address concerns about the need for a securities retail sales network to permit IPs to trade successfully as futures by taking up a proposal for cross-registration of securities account executives and futures associated persons. In response to concerns about futures-style trading systems, the Commission offered to look at a market-maker system along with rules for large order execution of IPs. Unfortunately, the CFTC's overtures were rejected by the SEC.

After the Court of Appeals ruled that IPs are futures, the Commission contacted the chairman, president and counsel for both the Philadelphia Stock Exchange and the AMEX, and offered to consider designation of IPs -- on an expedited basis -- on their futures exchange subsidiaries. Once again, the Commission offered to review cross-registration of AEs and APs along with proposed rules for different trading systems. Unfortunately, the securities exchanges chose to pursue their case in court and, as a result, IPs are not currently trading on any exchange, here or abroad. You should also know that the Commission supported the NYSE basket product -- a mechanism to trade a basket of stock replicating the S&P 500 index.

Recent trends in financial engineering have created new instruments that combine the characteristics of more traditional futures and securities instruments and that serve in varying degrees the functions of these traditional instruments. We fully agree that innovation needs to be encouraged. However, how will a change in jurisdiction guarantee that innovation will flourish? We think the record of the CFTC recounted here makes clear that we have, and will continue to, encourage innovation and will back up our words with action.

CONCLUSION

The Commission believes that the case for shifting jurisdiction over stock index futures to the SEC or for merging the two agencies simply has not been made. No problems have been identified that would be fixed by shifting jurisdiction. In fact, we think that a change in jurisdiction would lead to significantly higher margins on stock index futures, further restrictions of the trading of stock index futures and related strategies through up-tick and down-tick rules, side-cars, Designated Order Turnaround collars, and other regulations to restrict arbitrage, to name but a few. These policy changes could increase, rather than decrease, stock market volatility while impairing if not crippling the hedging function of stock index futures. Restricting the use of futures, either directly or by limiting index arbitrage, will impair market liquidity, performance and efficiency. Raising false hopes about reducing volatility through regulatory proposals that cannot accomplish the goal is bad public policy.

The Commission's position regarding stock index futures jurisdiction is clear. Stock index futures serve important economic functions -- price discovery and hedging -- the same functions performed by all the futures contracts the Commission has approved. We believe, as the 1988 Working Group Report pointed out, that margins on futures contracts should be set for the prudential purpose of assuring contract performance rather than being used in a futile and costly attempt to control market volatility. We believe that the same agency that regulates all other futures contracts should continue to regulate stock index futures. Stock index futures, too, require regulation by an experienced and expert agency; but, most importantly, by a price-neutral agency sensitive to the hedging and risk management function of futures.

Statement of

Dr. Wendy L. Gramm

Chairman

Commodity Futures Trading Commission

Before the

Securities Subcommittee of the

Senate Committee on Banking, Housing, and Urban Affairs

March 29, 1990

EXECUTIVE SUMMARY

Under the regulation of the Commodity Futures Trading Commission, United States futures markets are the world's largest, most liquid, and most innovative. Our regulatory system is a model imitated worldwide.

Those of us charged with making policy choices must work to sustain fair and open markets, financial integrity, investor confidence, and international competitiveness for all United States markets -- both securities and futures. As we make these choices we must distinguish fact from rhetoric, the goal of international competitiveness from the assertions of competing domestic interests, and distinguish between the different functions served by capital formation and risk-shifting markets.

We are here to discuss proposals that would radically change the current regulatory structure. Three proposals have been discussed publicly: (1) shift stock index futures jurisdiction from the CFTC to the SEC; (2) shift jurisdiction over all financial futures to the SEC; and (3) merge the SEC and the CFTC. The

Commodity Futures Trading Commission opposes any change in CFTC jurisdiction. The Commission does not believe a change in jurisdiction will resolve any of the real issues our markets face today.

Several assertions have been made that appear to motivate the proposals. It has been suggested (1) that stock index futures have driven individual investors from the stock market, (2) that stock index futures increase stock market volatility, (3) that their margins are too low, (4) that separate agencies cannot effectively police intermarket frontrunning, (5) that having separate agencies puts the United States at a disadvantage internationally, and (6) that the CFTC and the futures industry have stifled innovation. Careful examination shows, however, that the assertions are not supported by credible evidence.

1. Stock index futures and related trading strategies have not driven the individual investor from the stock market.

The evidence is clear. Stock index futures are not driving the individual investor from the stock market. Direct stock market participation by individuals has indeed declined, but not because of stock index futures. The decline has been going on for decades and is transforming the financial service industry around the world. The individual investor is still in the market participating through institutions such as pension funds and mutual funds. And the risk associated with investor positions is frequently managed with futures contracts.

2. Stock index futures trading does not increase stock market volatility.

There is no credible evidence in support of the contention that futures trading contributes to excessive volatility in the cash market. The overwhelming consensus of academic research on this issue concludes that futures trading does not contribute to cash market volatility. In fact several studies indicate that cash market volatility is diminished by the introduction of futures.

3. Raising stock index futures margins would not lower stock market volatility.

There is no credible evidence to support the contention that low margins for stock index futures cause stock price volatility. Calls for "harmonization" of margins must recognize the fundamental difference between the futures and securities markets, and the different settlement cycles and components of margin. The Working Group on Financial Markets, less than two years ago, unanimously agreed that for prudential purposes stock margins must be significantly higher than futures margins to provide the same level of financial protection.

The proof that the futures margining system works well is unequivocal. No clearing member firm defaulted in either October 1987 or October 1989.

4. Separate regulators can effectively police intermarket frontrunning.

Intermarket frontrunning has been described as trading in one market while in possession of material non-public information about another market. Futures exchanges actively monitor trading patterns for intermarket frontrunning. Despite allegations, there is no concrete evidence that intermarket frontrunning or any other intermarket trading abuse pose a significant threat to market integrity. Potential abuses are being addressed through coordinated monitoring and enforcement efforts within the existing regulatory structure.

5. **The existence of two agencies in the United States to regulate securities and futures markets does not put us at a disadvantage in international negotiations with the regulators from other countries.**

To the world at large, the CFTC and the SEC are regarded as the leading regulators of futures and securities markets, respectively. Our markets have prospered under the current regulatory structure. We see no reason to change our system to parallel foreign authorities. In fact, while some other countries' regulators may appear in their organizational charts to have only one agency in charge of securities and futures products, in practice bilateral negotiation often means working with several bureaus or divisions within the same governmental organization.

6. **The futures industry and the CFTC have not stifled innovation. In fact the CFTC worked to accommodate IPs trading.**

The CFTC's record on encouraging and accommodating innovation in financial products and trading systems is excellent. The United States futures industry has been the leading innovator of financial products, many of which it created within the past 15 years. After fifteen years of growth and development, financial futures and options have transformed the way institutions, including the United States Treasury, manage risk with significant benefits to the participants in these markets.

With regard to index participation units (IPs), the CFTC made significant efforts to allow IPs to trade. Staff from the CFTC and SEC met on numerous occasions to try to resolve the regulatory issues. In response to concerns about futures-style trading systems, the CFTC offered to look at a market-maker system along with rules for large order execution of IPs, and to consider cross-registration for securities account executives and futures associated persons. Unfortunately, the CFTC's overtures were rejected by the SEC.

Since the issue under discussion is shifting jurisdiction to the SEC, it is only appropriate to also examine the record of support for innovation at the SEC. If the CFTC had not been a separate independent agency during the past 15 years, would we have seen the growth in products that has made the United States the financial futures and options center of the world? It is doubtful.

Recent trends in financial engineering have created new instruments that combine the characteristics of more traditional futures and securities instruments and that serve in varying degrees the functions of these traditional instruments. We fully agree that innovation needs to be encouraged. However, how will a change in jurisdiction guarantee that innovation will flourish? We think the record of the CFTC recounted here makes clear that we have, and will continue to, encourage innovation and will back up our words with action.

In conclusion, the Commission believes that the case for shifting jurisdiction over stock index futures to the SEC or for merging the two agencies simply has not been made. The Commission's position regarding stock index futures jurisdiction is clear. The CFTC should continue to regulate stock index futures. Like all futures, stock index futures require regulation by an experienced and expert agency; but, most importantly, by a price-neutral agency sensitive to the hedging and risk management function of futures.

Senator DODD. Thank you very much, Dr. Gramm. And let me thank all of you for your statements and brevity.

For purposes of working here, why don't we limit ourselves to about 10 minutes apiece, if that's all right with my colleagues.

After listening to all of you, it's hard to believe we're talking about the same country when we hear as many differing points of view on whether or not we've got problems. Normally, you would expect the private sector to be on one side and the regulators to be on the other side and you might hear that kind of a debate, but to have the regulators in front of us and hearing that kind of disagreement——

Chairman Greenspan, let me begin with you. Obviously, we listened to your testimony and heard the Board's view, but I do want to ask you what your own personal views are regarding stock index futures jurisdiction, whether it should be left with the CFTC or transferred to the SEC. In other words, in your view, do we need a single regulator over stocks and stock derivatives, and who should it be? And obviously the next question—and I'll give you a chance to respond to both of them—is on the margin issue. Again, I would like your personal observations on that.

I think there was a rather clear statement on the first one. On the second one, the margins, I was left more in doubt as to even the Board's view on that, but I'd like to hear your view as to how that ought to be handled.

Mr. GREENSPAN. Mr. Chairman, let me reverse the questions, if I may.

I think the Board, as best I can judge, is unanimous on the question that the appropriate margins for stock index futures and for stocks should be prudential only. It is very difficult to determine what constitutes the appropriate level of prudential margins, but I think we have asked ourselves time and time again in recent years, does the issue of the level of margins affect volatility in the stock market? Had we found such a relationship, I suspect that we would be arguing that margins should be constructed in a manner which picked up not only prudential requirements but also an element of additional margin which would act to presumably suppress the degree of volatility in the system.

All of the analytical tools we have brought to bear have failed to find any such relationship. As a consequence of that, we are unanimous on the issue that prudential margins are the realistically sole purpose of putting margins in place.

On the question of the jurisdictional issue, as I raised in my prepared remarks, there are basically two fundamental, necessarily conflicting pressures when you decide issues of jurisdiction because it is desirable to have, other things equal, a single regulator for a single exchange; but on the other hand, it is desirable to have a single regulator for all products which relate to the same price-making mechanism. In the case of stock index futures, which tie very closely to the cash markets, that argument suggests that there should be a single regulator.

No matter how you choose this, it's going to come out wrong in one direction or the other and I think all of the Federal Reserve Board members have varying views.

We were very close to consensus but we shifted in different directions. I came out very slightly on the side of moving all index futures to the SEC, but I will tell you it is a very close call, and it is not something which, in my judgment, is self-evidently demonstrable as desirable because it does create problems on the issue of regulating exchanges.

Senator DODD. Would you clarify your position as to which of the regulators ought to set margin requirements?

Mr. GREENSPAN. With respect to stock index futures?

Senator DODD. Yes.

Mr. GREENSPAN. I'm saying that because I think there should be a single regulator for the product, that is, the combination of stock and stock index futures—should be and I would tend to be just marginally in favor of the SEC being in control of both.

Senator DODD. Thank you for your clarity on that.

Let me ask a question of the panel because you're all part of this Working Group. Senator Heinz and I just spent about 8 days in the European Community. We went over to discuss a narrow issue—the access a single European market for American securities items and banks—but it's impossible to go over there and deal with only one issue, as you realize how many questions are raised by the single market initiative.

One thing I was certainly struck by, and Senator Heinz can certainly share with you his views on this, but there you had 12 countries with as much difference as exists historically, culturally, economically in many instances, and yet they are moving together very quickly. I was stunned by how fast. I don't think there's an appreciation here of how quickly this is happening and what we're going to be confronted with.

I get the sense that there's a view here that this is still an academic exercise in Europe but it's not at all.

Here we find directives being issued by the European Commission, dealing with highly complex matters with significant differences, and resolving them rather quickly.

What strikes me, coming back, is here we have none of the problems that the European Community faces, and we can't even seem to get an agreement on an issue as simple as margins here. When you start looking at competitiveness questions in the future, why are we incapable of getting our act together in a sense? I'm dumfounded as to why it's impossible for us to reach some consensus agreement here on how to move on issues that don't even begin to approach the complexity that the European Community is facing.

I'll begin anywhere you would like. We'll begin with you, Mr. Glauber, since the Treasury is responsible in a way.

Mr. GLAUBER. On the specific issue of margins, I think that the issue is a complex one and I think it is one where professionals can legitimately disagree.

The Working Group has served as a forum for a healthy debate on the margins issue as well as on broader issues. We all agree that margins should, I think, serve the function of a prudential safeguard.

The question goes obviously beyond that and there is disagreement there.

If I may at this moment, let me just make clear Secretary Brady's view and my view as well, of course, on the margin issue.

I don't think there is a great deal of persuasive evidence that the average level of volatility has increased, but I don't think what we are particularly talking about is the average level of volatility.

What we are talking about is the potential for brief, violent disruptions which could be caused by the activities of leveraged traders in the futures market and the effects of that sweeping back into the stock market.

While averages are important, averages don't tell the whole story. The well-known saying goes, "it's possible for somebody to drown in a river whose average depth is only one inch." So that it's necessary to look beyond those averages.

As to why we disagree, I think there are disagreements in philosophy. There are disagreements in the reading of the evidence. There are disagreements in the evidence that we look at.

We, on the Brady Commission, looked at the behavior of individual investors during this period in October 1987, and saw what to us was persuasive evidence that individual leveraged-trading-oriented institutions could move into one or the other markets and shift forces from that market into the other one and thereby accelerate and make more violent the downward spiral. Others would disagree.

Senator DODD. Let me come back to you, Chairman Greenspan, as well on this one. Are you concerned at all about what is perceived as the balkanization of the regulatory system while simultaneously the private sector is developing multiservice financial institutions which cut across regulatory lines? It seems to me we're going in opposite directions.

Mr. GREENSPAN. No, I'm not, Mr. Chairman. I think that we have to be concerned about the issue of over-consolidation of the regulation of the financial system and fragmentation.

On the surface the issue of efficiency is very clearly served by complete consolidation of all regulatory functions under a single head, not even a commission—a single head.

From a regulatory point of view, I would suspect that would give you the most consistent regulation, probably also the most stifling.

The reason for that is that in human affairs, whether in business, whether in Government regulatory organizations, whether we're in any activity, competition is a very effective tool. And while I certainly grant that the emergence of international competition for a number of the products we produce is increasing and is very helpful, I feel that we would probably be ill-served by too much consolidation because it is very likely to lessen the interest in the development of new products. While that is a very difficult thing to prove when dealing with human psychology and evidence which is very thin, that would be an impression I would have.

As a consequence of that, I feel uncomfortable about the thought of trying to push our organizations into a single head.

I might just say, parenthetically, were I convinced that the current Chairman of the SEC would not eventually go on to better activities, I would feel comfortable with him. It's his predecessor, whoever that may be, who I may not be comfortable with. I mean successor. David will forgive me.

Senator DODD. I was going to correct you even if you didn't want to be corrected. I want the media to stay for the rest of this hearing. [Laughter.]

Mr. GREENSPAN. David Ruder will forgive me I am sure. He owes me a couple. [Laughter.]

In any event, I would think very hard before we removed that competitive edge which I think does exist in our regulatory infrastructure, and I think does serve us well.

Senator DODD. My time is up, but I'll give both Mr. Breeden and Dr. Gramm an opportunity to respond to that question if you'd like.

Mr. BREEDEN. Mr. Chairman, I will just briefly agree with Alan that these are questions of balance. There isn't a guaranteed right way or a guaranteed wrong way to structure a regulatory system. You have to design institutions that will work well over a period of decades and that can deal with both the calm times in the market and the worst troubles the market might experience.

When you build a bridge, you do not build it to handle the weight of the average car that goes over it; you design it to handle the weight of the heaviest vehicle that may go over it. Therefore, in order to protect the public, it's important to look both at what will work well in day-in, day-out activities, and at what will work well when the market is experiencing extraordinary stress. None of us would like to repeat the market collapse of 1929 and none of us would like to see problems that could have been controlled turn into much, much bigger and deeper problems.

The question is, how do you do it? How do you design a system that is least likely to allow problems to grow to unmanageable proportions and also is least likely to impede competition that produces vital efficiency? Choosing between these competing objectives necessarily requires a tradeoff.

I think it is helpful to focus on the goals we are trying to achieve. The regulatory structure we have is a structure largely designed in the 1930's. That structure is one in which there are a number of barriers, not just between stocks and stock index futures, but between banking and securities and insurance and depository institutions. The interest groups that have sprung up around those barriers are very good at arguing that their own segment of the pie ought to be protected. I think we also have to step back occasionally and look at the big picture and say "What's the best way of doing things for everyone, for the entire system?"

I think that's what each of us is trying to do. No one here has a monopoly on wisdom.

I would like to correct the record on one matter, since an allusion was made to my predecessors. Since 1983, the SEC has had pursuant to congressional action the authority to veto new securities index products. It's not necessarily a well-known fact, but it's part of the legislation Congress enacted as part of the Shad-Johnson Accord.

We have looked at literally tens of proposals in this area in the last 7 years, and, while we've made a lot of suggestions for improvement, we have not vetoed the introduction of a single one of those new products.

Furthermore, to my knowledge, we have never once in our entire history disapproved an application by a securities SRO to bring a new product to market.

Therefore, I do not believe it would be accurate to suggest that the SEC is somehow anti-competitive. I think if you look at the scope of new products brought to the securities markets in the last 60 years, it's very clear that we are a highly pro-competitive agency. Thank you.

Senator DODD. Dr. Gramm.

Dr. GRAMM. The SEC did oppose, in a letter to the CFTC, before the Shad-Johnson Accord, the introduction of stock index futures and, has on occasion held up, but not disapproved, the trading of other stock index futures.

I think Alan raises a very good point about the issue of innovation and uncertainty, as well as new products. I would say that there are really only two conditions under which you're going to totally get rid of regulatory uncertainty, court cases or litigation that may inhibit innovation. There are only two ways.

One way is if there's no innovation and the other way is if there's no regulation at all and no Government entity. I would posit whenever you have regulation and any Government entity that there will always be new products, new processes, new ways of doing business where Government regulation that can impede innovation and progress and create uncertainty.

As you know, even the SEC over the years before the CFTC was formed created uncertainty in defining securities. There were many court decisions over what a security is, for example, and uncertainty at the edges of the law. That's what innovation is and that's always going to exist.

In the case of IP's, it simply was the case of what is a future, which is different than a security. A security is an asset. A future conveys no ownership interest at all. And the court simply said this product is a future and not a security and therefore had to come under the futures regulations.

But I would posit that same kind of "uncertainty" would always exist even if there were only one agency. And I would also say that IP's could be trading today because we tried to deal with that problem and solve it. They could have been trading and being sold today. The Philadelphia-type product. There is another type product that indeed the CFTC recommended the SEC approve that is being traded today on the New York Stock Exchange. It is a real security.

Senator DODD. I went longer than 10 minutes so I'm going to extend the time to 15 minutes. Senator Gramm.

Senator GRAMM. Mr. Chairman, I've read everything that I have been able to find on the debate about margins, and I have reached the conclusion that the margins debate is not about safety. The margins debate is about competition, and it is about competition between two markets. I have seen no evidence to substantiate any claim that the debate about margins is anything other than a debate about one market singing the blues with no let-up in sight. That's what the margins debate is about, and that's what all the calls coming to Washington, DC are about.

Bob, let me begin by asking you a question. And I know, that not being an elected official, you don't have perfect knowledge and the ability to deal in certainty.

But let me ask you, in your opinion, had the SEC in 1982 exercised control over the market that was to become the stock index futures market, do you believe that this market would have ever come into existence?

Mr. GLAUBER. Senator Gramm, I apologize, but I simply cannot answer that.

Senator GRAMM. What do you think?

Mr. GLAUBER. I just simply do not know. I think the concern you suggest is a legitimate one about the potential for stifling regulation. I have no way of knowing what would have happened in 1982.

The point I would like to emphasize, though, is today is very different from 1982. There is competition throughout the world. It will be impossible, I think, for a regulator to stifle innovation and, indeed, what we have is a situation that works just the opposite way. We have a regulatory scheme which itself is stifling innovation.

I concur with you completely that we have to promote innovation and that's why I think we have to do something about the regulatory scheme we have.

Senator GRAMM. Richard, let me ask you a question. You say in your opening statement that you're before us today to express the views of the Securities and Exchange Commission. I see in the New York Times on March 18, 1990, a statement by Edward Fleischman, who is a commissioner. Let me just read you what it says, and then I want to read to you from the Wall Street Journal what Ms. Schapiro says. Then I'm going to pose my question:

> Edward H. Fleischman, an SEC Commissioner, thinks that the two regulatory bodies actually promote more innovation than they suppress. The CFTC has been much more willing than the SEC to let exchanges develop new products, and he wonders whether the SEC would be able to regulate futures markets as effectively as the CFTC.
>
> We really don't understand those markets. It is a different world. The SEC has not earned a stellar reputation for its regulation of options. You tell me what we would do differently. I would venture to say, nothing.

The other excerpt is from the Wall Street Journal: March 21, 1990:

> Ms. Schapiro, who is a SEC Commissioner, who has been asked by Mr. Breeden to be the lead negotiator with the CFTC over regulatory issues, opposes the idea of switching jurisdiction over financial futures or just stock index futures to the SEC from the CFTC. Moreover, she said that switching stock index futures to the SEC could tempt the securities agency to regulate them as securities which would hurt the products' worldwide competitiveness.

Now do you speak for these two commissioners when you say the things you say in your statement?

Mr. BREEDEN. Yes, sir, Senator. The testimony that we gave is testimony of the Securities and Exchange Commission, a body currently composed of four commissioners. Like the individual members of the Board of Governors, they each have their own views on these subjects. We debate them, as we do all subjects, vigorously, openly, and there are sometimes differing individual views. But the testimony we have submitted is testimony of the Commission, not my own personal testimony.

I might add, since people keep raising Commissioner Schapiro's comments, that she was very concerned that her views not be mischaracterized. She feels that the status quo is simply untenable, unwise, and ought to be changed. Those remarks were in the context of arguing for a merger of the agencies into rather than the less drastic alternatives that Secretary Brady has also enunciated—transferring all financial futures or merely stock index futures. But she firmly believes—and I'd be happy to let her confirm this—that the system needs to be changed and that, of the alternatives, the best change is a merger of the agencies.

Commissioner Fleischman also believes that, if there is to be a change the best alternative would be a complete merger of the agencies, as indicated on page 19 of our testimony in the footnote.

Senator GRAMM. Mr. Chairman, I think it would be useful if we might ask the members of both commissions to submit their views on the issue of stock index futures. I think it would be valuable to have it and I would like to ask—I will simply submit the question and then ask that it be given.

Richard, you used an example earlier about how much one could tie up in equities with a certain amount of money, and you talked about the investment in the equity directly, and you talked about the futures. You didn't talk about options.

In that same example, what could I tie up with options?

Mr. BREEDEN. I can't give you the dollar number because the margin level varies somewhat based on the particular option and the type of instrument. In all cases, there is a minimum margin that I think in the most directly comparable case would have been 100 percent of the premium of the option plus an overage of about 15 percent, which would translate to about a 15 percent margin level.

Senator GRAMM. But in terms of tying up, as you called it, I could call up considerable stock value with $100,000 using options. Is that not right?

Mr. BREEDEN. But far less than you could use the S&P 500 futures contract. As I tried to make clear, margins serve different functions in the different markets, and I have not urged that there ought to be 50 percent margins for futures or that they need to be identical to margins in the stock market. I think the objective, as Alan, Bob and I have all said, is to try to develop a system of prudential levels that are sufficient to protect the system and the American public. As an institutional matter, I don't think that the boards of directors of private exchanges should be the ones who are designated to protect the public in this area.

Senator GRAMM. Well, are they not protecting themselves? Aren't they the people who are going to lose money if there is a default in the clearance process?

Mr. BREEDEN. Well, that's true, but in protecting themselves they may create risks for the rest of the market. On October 13 and 16, 1989, margins on stock index futures started about ½ inch from the edge of a cliff, about as close to zero as you could get, about 2.2 percent for most categories. When the market began to plunge, the futures market sharply and dramatically raised those margins. The result was about $1.3 billion in margin calls on those two days.

Those actions drain liquidity out of the system and create the risk that margin calls will necessitate further selling.

Senator **Gramm**. I think you've put your finger on a difference in approach that you have as compared with the approach I have. I view margins as being something required to provide safety. You view them as an instrument of Government controlling liquidity. I think that is a fundamental difference in approach.

As I look at this thing—I invest in groceries since I'm poor, and so I have a hard time conceiving all this stuff, but I try to think of it in the following way. If I went out to buy a house, I've got two different margin requirements. I've got a margin requirement that if I want to buy it I've got to put up earnest money and I might tie up a $1 million house for $10,000, and if I don't go through with the contract they are going to keep my $10,000. On the other hand, I can't go out and buy a $1 million house with $10,000, because in terms of borrowing the money I have got to put down a margin requirement that represents what the average guy in the street would call a downpayment.

Now where I get off the train on all this discussion is in trying to convert it in my simplistic mind and trying to understand it. You're trying to argue that something is crazy because I can put down $10,000 in earnest money on a $1 million house of $10,000, while I can't borrow $1 million to buy a $1 million house with a $10,000 downpayment.

I don't see those as in any way being comparable.

Mr. **Breeden**. As I said, I agree that there are differences in the function margins play in the various markets. I would just like to emphasize, Senator, that I'm not trying to create a system for liquidity controls. I'm not saying that we're concerned about the impact of margins on daily volatility. Those aren't my points at all.

My point, which I believe is shared by the Treasury and what I heard in Alan's testimony, is that we all think there needs to be some Federal oversight of margin levels, that gives attention not just to protecting the futures traders, but to protecting the market itself. For the same reason, we have found it necessary in the last 12 months to pass a law re-establishing limits as to what the maximum loan-to-value ratio should be on home mortgage loans, to make sure that prudential considerations are given appropriate weight.

Senator **Gramm**. But you haven't passed a law on earnest money. Let me make my point going back to my example.

What I'm saying is this. It makes perfectly good sense if I am a futures dealer that when you've got greater volatility, when I am more worried about people actually fulfilling their contract, that I would want a higher margin because I'm trying to cover my investment. It's my money.

From the point of view of the regulator, however, who has an overall public interest, you would want margins to actually be declining under those circumstances.

Now I'm saying both views are legitimate, both views are right, but they are fundamentally different views. And the question you've got to ask is, should margins be used as a public policy tool to promote liquidity or should they be used as a private policy tool, either as imposed by the Government or through private agreements, to provide security?

I'm saying that those are legitimate views, but they represent totally different views of margins. So I think we are arguing here not about a difference in fact, but about a deep philosophical division as to what margins are and what their functions are.

Bob, do you want to comment?

Mr. **Glauber**. If I might. Even if we think of margins as earnest money, I think even there there's a question of whether the private clearing houses can be asked to make the entire decision on their level.

Suppose a clearing house sets that earnest money requirement too low for its own self-interest. Will it bear the full cost of that mistake? I think not. I think if the clearing house were to be jeopardized and get into trouble, the entire clearing system could be jeopardized by that. There really is a public interest in the level at which the clearing houses set the earnest money level, even if you limit it to that concern.

That's why, even from that perspective, we have proposed that there be public intervention in the setting of futures margins even if it were just for the so-called prudential purpose.

Senator **Gramm**. Who do you think should set those margins?

Mr. **Glauber**. I think that there are a couple of choices. I think it should be unified. I think the same person who sets margins for stocks and options should set it for futures. The Fed currently is responsible for stocks and options. To put them at the Fed would make sense for that reason or they could all be shifted to the SEC.

Senator **Gramm**. Let me move to Alan. The Fed sets equity margins because margins represent a downpayment on the loan. The margins on a future represent earnest money. Let me turn to Alan. Would you see the Fed as being the logical place to put the margin-setting for something that does not involve credit?

Mr. **Greenspan**. No, we do not. In fact, increasingly, margins are becoming not an issue of liquidity in the system, but essentially something that, if necessary, moves against systemic risks.

As you know, Senator, I am very sympathetic to your philosophical point of view.

Senator **Gramm**. I know, Alan. That's why I like you. You have a good heart and a good mind.

Senator **Dodd**. We haven't heard whether or not Alan likes you.

Senator **Gramm**. Alan loves me.

Senator **Shelby**. Gramm wouldn't care whether he likes him or not. He wants to know if he agrees with him.

Mr. **Greenspan**. I've seen many showstoppers in my day and that's as good a one as I've seen.

The question really gets down to whether or not there is potential systemic risk that is involved in private actions in this particular case. And to the extent that private actions create problems or incursions on other people's property, I think that there is a purpose here for governmental oversight.

I don't come to this issue with a long-standing belief in the fact that there should be governmental oversight of margins. In fact, I come from exactly the different direction: I have always argued that self-regulatory agencies should do it themselves, and the Government should be completely uninvolved.

I regret to say that the behavior of margin-setting in the last couple of years has shaken my confidence in that view, and I was quite concerned on that Monday which Richard Breeden was talking about, with being confronted with what we all considered an unstable situation and a significant increase in margin requirements being required on that Monday morning. I think that I was shaken by that event.

I thought that clearing houses and exchanges have got to think about the long term, about the basic fundamentals. In that respect, I have reluctantly shifted to a position where I think there is a systemic risk question here, as indeed has the Federal Reserve Board. We disagree as to where the supervisory oversight should occur, but we have agreed on the issue that there should be some oversight, and I think I've seen a lot of views change among my colleagues with respect to that issue.

I must tell you, I regret it. I don't like that idea at all. But facts do matter, and I must say that I have been persuaded by them.

Dr. GRAMM. Can I respond to that?

First of all, you need to know that there are other ways and other methods of protecting against a systemic risk, including capital requirements and other guarantees.

Second, we still have to look at what the evidence is. Do we have evidence, for example, that there was a sell-off because of people having liquidity problems on October 13. We have looked at that and actually on October 13, only one of the 60 largest net position changes represented a long liquidation by a speculator. But that long liquidation was a large commodity pool and, as you know, they are not going to be liquidating because of margin calls.

Third, I can appreciate the concern over Government oversight and would not argue that we just do what other international regulators are doing in the area. However, for your information, no other governmental regulator has margin authority in the other countries that do have stock index futures.

Finally, I guess it does come down to the philosophical question and that is—are we going to have Government regulation to protect against what might be business mistakes, given the evidence of not having had a problem even in October 1989 or October 1987, and also given the fact that there are other funds to be used should the market move very rapidly.

Senator GRAMM. Thank you.

Senator DODD. Thank you very much. Those were good questions, Phil.

I would just add here—I've just been handed a speech that President Corrigan of the New York Federal Reserve gave on January 25, in which he raises many of the same concerns that you do about systemic possible risks when the exchanges set those margins themselves, and I will place his remarks in the record in the context of your debate. I think it's a good one and you ought to have that as well.

Senator DODD. Without objection, so ordered.

Senator Shelby.

Senator **Shelby**. Thank you, Mr. Chairman.

I won't spend all my time on the margin requirements. We've had a pretty good debate on that.

I am concerned—since I don't represent Chicago or New York in the Senate, I am concerned about the two markets, but it looks to me from up here that the two markets have served this country well. Perhaps we don't need to change anything. I might disagree with my friend, Richard Breeden, on that. I would like to see more evidence there because it seems that the Chicago people as we call them have been so creative to bring forth new products that have transformed so many things in the financial arena, as you would concede I'm sure.

So why change it? Why change or over-regulate or centralize the regulation of something that seems to be working and working well? That would be my central question to all of you. I think that is the jurisdictional question here.

The second thing I want to raise—and then I want you to comment on that and this, too—there's been allegations that the small investor has been driven from the market because of the innovative products that have come out of the commodities end, but isn't there evidence that the small investor has just been reincarnated, has come back into the market through the institutional investors or through the mutual funds and other ways? This has been going on a long time. It may have been accelerated.

I would like to ask, Ms. Gramm, do you want to comment on those first? First, the jurisdictional; and second, have we really driven out the small investor?

Dr. **Gramm**. I agree that the case really has not been made for merging or changing jurisdictions. In fact, these are innovative, world-leader markets and, furthermore, the development of stock index futures and financial futures has not harmed the underlying equities markets. In fact, there are more recent studies to indicate that they indeed help the markets, just like futures in other products. The extent to which you can protect against price volatility——

Senator **Shelby**. And they stabilize the market at times.

Dr. **Gramm**. There are studies to that effect. In fact, the extent to which people can protect against price risks in any commodity may enable them to hold more than they would normally hold.

On the issue of the small investor, the retreat of the small investor—in terms of holding equity assets started back in the late 1960's and continued through the 1970's before stock index futures were even developed. Indeed, they are indirectly in the stock market through pension funds and mutual funds.

Senator **Shelby**. Chairman Greenspan, I think you've been through the jurisdictional dispute already and I noticed a lot of hesitation, perhaps reluctance, perhaps doubt, that what I would ascribe to some of your words—personal opinion versus the words—whether or not we should do that as far as the jurisdictional thing. It's no clearcut decision there or recommendation, is it not?

Mr. **Greenspan**. I think that's right, Senator. I think that the reason why you are seeing this much in the way of debate is that it is not a clearcut issue. It's a tradeoff, and not a clear choice, and I think we all come out one way or another, but fully recognizing that there are persuasive arguments on both sides of this issue.

Senator SHELBY. And if there's some doubt or reluctance, perhaps we should leave it like it is. This would be my opinion.

Bob, have you got a comment? I know you represent Treasury here and you have an opinion, at least Nick Brady does. Go ahead.

Mr. GLAUBER. I do as well. I think the point is obvious. As Chairman Greenspan has said, this is not an easy choice. There are arguments for changes in regulatory jurisdiction.

Senator SHELBY. Not only easy, it's perhaps not even a clear choice.

Mr. GLAUBER. I would accept that as well. If it were a clear choice, then all of us, being reasonable people, would agree. So it prima facie is not.

I think the question is to weigh the pros and cons, the benefits and costs of any change. Recall that the original decision to regulate stock index futures was one that was made when they were invented in 1982, long after the CFTC was invented, and a decision was made to put options over with the SEC and stock index futures with the CFTC. That is, that they looked more like futures than they did like stocks or that their maturity aspects made the CFTC the more appropriate regulator.

We have now had considerable experience and have seen how these instruments trade and I think one of the so-called discoveries of the Brady Commission report was that this is really one market and I think everybody more or less accepts that.

The question then is, will we benefit from having the regulation redrawn to reflect the one market? And I think at the margin the answer to me is quite clearly yes because I don't think the system is working well enough that we can be satisfied with leaving it the way it is. I think, as we've said several times, the system is getting in the way of innovation now rather than——

Senator SHELBY. There are opinions on both sides whether it's working well enough, are there not?

Mr. GLAUBER. I think that that's right. I have dropped my role of speaking for all of my colleagues at the table, if ever I had such a role.

In my view and in Secretary Brady's view, it is in some aspects not working well enough and one of the important ones is innovation. I think enforcement is another one. It is very hard to enforce intermarket manipulation rules when you have two very good regulators working in separate markets. I think there are other market mechanisms, beyond margins, that are not being coordinated as well as they should be.

Senator SHELBY. Let me stop you a minute. We all know, as you well know, that the SEC has had its problems with fraud and everything else in their area just like they have in Chicago, but both are trying to weed it out.

Mr. GLAUBER. Absolutely. Again, as I said in my prepared remarks, I do not in any way want to criticize the vigilance or effectiveness of the individual regulators. I think they are being asked to do something they were not designed to do, and that is to deal with intermarket manipulation, front-running, these issues. And I think that is a result of the way we happened to have configured regulation. We drew the line one place in 1982.

While I would not hazard a bet, it might well be that if we were confronted with starting anew today knowing what we know, we might draw that line differently. Other countries have drawn that line differently and I think at the margin the clear weight is on redrawing that line.

Senator **Shelby**. Since we're the clear leader and I'd like for us to stay there in dealing with financial matters, both stocks and futures and so forth, should we go back and look—I know we should consider and be knowledgeable of what's going on in other countries, but should we go back and pick up what they are doing when ours perhaps might be working and is on the cutting edge in perhaps a greater way?

Mr. **Glauber**. We certainly should not be slaves to what others do.

Senator **Shelby**. That's what I'm getting at.

Mr. **Glauber**. I wouldn't suggest that. I think, though, we ought to look and see what are the problems in what we are doing ourselves now and ask whether we can make—not radical changes, not changes to increase regulation—I share Senator Gramm's view that what we do not want is increased levels of regulations. I believe what we can accomplish is less regulation, more effective regulation, more streamlined regulation.

Senator **Shelby**. Or stifle creativity by too much regulation.

Mr. **Glauber**. We certainly do not want to do that.

Senator **Shelby**. Dick.

Mr. **Breeden**. Thank you, Senator.

I would agree with many of the preceding comments. I think it's useful to look at this as not one big issue but to consider the three separate areas that we've talked about—exclusivity, margins and jurisdictional change, and acknowledge that these are tough questions. Reasonable people do differ on them. And in all of these financial market concerns, when you wait until you have absolute, complete and total unanimity of everyone in the country, sometimes you owe a $200 billion bill by the time you fix the problems if you've let them get out of control.

Senator **Shelby**. There's a lot of difference between a lot of hesitation and doubt and close calls on anything and a clear reason why we should do something.

Mr. **Breeden**. I agree, and I'm not saying——

Senator **Shelby**. You can obviously tell there's a lot of doubt in the Congress and even right here on this panel.

Mr. **Breeden**. And I think that it is important to search for the best possible blend of what are trade-offs.

On the issue of exclusivity, we would all like to promote competition. The U.S. share in the world equity markets has been declining sharply for the last 10 years. It's been declining very sharply in stock index futures for the last 2 years or so. So we don't have a hegemony in either set of markets, and I think if there are symptoms of problems we ought to try to correct those problems, not do radical surgery. I want to see a strong market for stock index futures in this country. I think it's in America's national interest. I want to see strong agricultural markets. That's in the U.S. national interest.

The question is, what's the best way of doing it? In the new products area, this system works very well for introducing new products in Chicago, but it doesn't work very well for introducing new products for banking or securities or insurance. The colloquy that Senator Heinz was engaged in earlier this morning regarding the so-called IP's products is a very good illustration, and I don't blame any agency. The fact is that there were 74 million IP's traded over about a 6-month period—74 million IP's. That suggests that there was a fair amount of investor interest. IP's were playing some productive part in the American capital system, and they are not available today in the United States of America. You have to go to Toronto to buy those products. A system that produces that kind of result has a flow. We should not abandon the whole system. We should instead fix the flaw that produces the restraint on competition. We should keep the benefits and fix some of the problems.

As to margins, again, I don't think we ought to come in with a bulldozer and say everything has to be leveled out and be exactly identical. I think we all share concerns relating to some of the trade-offs that must be made in that area, but I come down on the side that we need to do a little more to reduce the possibility of repeating events severe as the market crash of 1929.

And when we consider how to do that, we must remember that there are costs of going too far. We have to be very careful, and that's why this kind of inquiry is so beneficial. It ventilates these issues, so that a balanced judgment. Can be made.

Senator **Shelby**. What about the small investor? Has he or she actually come back into the market in another form?

Mr. **Breeden**. Well, first of all, let me say that among the canards that sometimes fly around in this debate is the one that the departure of the small investors from the markets is the reason why these issues need to be addressed. I certainly have never argued that.

Senator **Shelby**. Other people have argued that.

Mr. **Breeden**. Well, some do. I am very troubled by the issue of confidence of investors to participate in the markets. It's good for America to have strong, widespread participation in our capital markets, and I think the violent swings that have occurred over the last few years trouble millions of people. Judging from the letters that we get at the SEC, we're not making up that problem. There may be hundreds of factors that contribute to there violent swings but the fact is that the swings are faster now, the market moves more sharply than it did in previous years, and that does have an impact in undermining confidence. You're absolutely correct that one of the results of these price swings has been to lead individual investors to participate more actively in mutual funds and other forms of managed portfolios. What we want to do is try to design a system that will encourage investors to participate, either directly or indirectly, because their confidence in participating in the market is good for America. It reduces the cost of raising capital, so that American companies can be successful in making and selling products all over the world.

Senator **Shelby**. Thank you, Mr. Chairman.

Senator DODD. Thank you, Senator Shelby.

Senator HEINZ. Mr. Chairman, thank you. I'm sorry I missed some of the other questions, but I had to go to the floor to make a statement on pending legislation. I apologize.

As I listened to the testimony here earlier, what I heard was that most of you—not everybody—most of you think there are some serious problems that have to be addressed.

One that was mentioned more than once was that there is the problem of retarding innovation. Index participations are a casualty of, in part, the exclusivity clause.

I think it was Bob Glauber who mentioned that business is being driven offshore in the form of commodity swaps. Again, because of the combination of open outcry with the exclusivity clause being inconsistent with doing commodity swaps of that kind. Is that correct?

Mr. GLAUBER. That's not the one I mentioned but I will mention it.

Senator HEINZ. Is that a problem or not?

Mr. GLAUBER. I think it is. I think again the potential for driving away business from these markets in instruments other than just IP's—commodity swaps and swaps in general—would be one of them.

Senator HEINZ. We've also heard a bit about margin regulation. Chairman Greenspan indicated that someone ought to regulate the margins. He doesn't want it to be him, but there ought to be a Government regulatory mechanism for stock index future where it's currently under self-regulatory organizations as opposed to a public interest regulator. Moreover, the issue of intermarket manipulation was just mentioned by Bob Glauber.

Do all of you agree that there is a potential problem of risk from intermarket activities that can't be picked up by the present bifurcated regulatory system? Chairman Breeden, do you share Mr. Glauber's concern?

Mr. BREEDEN. Yes, I do. It's more difficult to delete intermarket manipulation.

Senator HEINZ. Chairman Greenspan, do you share that concern as well?

Mr. GREENSPAN. Only partially. I'm more concerned about the issue of the particular setting of margins. In fact, that's my major reason for tilting in the direction of moving stock index futures.

Senator HEINZ. Chairman Gramm, how do you feel about the concerns that Chairman Breeden and Bob Glauber have on that point of intermarket manipulation?

Dr. GRAMM. Intermarket manipulation, not margin?

Senator HEINZ. Intermarket manipulation.

Dr. GRAMM. I'm glad you raise that because I am very frankly puzzled by the concerns raised over our ability or lack of ability to enforce the law here. As you know, intermarket manipulation or front-running has arisen as an issue since the 1987 stock market crash. In fact the intermarket surveillance group, which included the futures exchanges, sought to establish definitions and to share information. As early as September 1988, the New York Stock Exchange and the Chicago Mercantile Exchange agreed on a common definition of what that intermarket front-running would entail. Our rules went into effect that month, in 1988.

The SEC rules for the New York Stock Exchange didn't go into effect for another 10 months.

I would add that the four futures exchanges have intermarket front-running rules that have been approved, while the New York Stock Exchange is the only equities exchange where the current rule on intermarket front-running involves futures. In fact, CBOE at this point in time still does not have a definition that agrees with the other exchanges.

Senator **Heinz**. That wasn't the question I asked.

Dr. **Gramm**. I'm getting to the answer. Also, just recently in March 1990, the CME and New York Stock Exchange began routinely sharing information that we have from our large trader reporting data and that the New York Stock Exchange will be getting from its program trading report in order to find intermarket front-running. So I don't see a problem here.

Senator **Heinz**. Here's the thrust of my question. If somebody commits bank robbery in Pennsylvania and they go where all good bank robbers probably want to go, Texas——

Senator **Gramm**. We hang them in Texas. In Texas they will get killed. [Laughter.]

Senator **Heinz**. We put the FBI on the case in Pennsylvania but they get to the Texas border and they say, "I'm sorry, jurisdiction is transferred to the Texas Rangers at this point." Although it may make this fellow to my right happy, does that make a lot of sense?

Dr. **Gramm**. That situation doesn't occur at all in this case. There has never been a case where the SEC said, "We have front-running in our market and we need your help" that we haven't given it. As a matter of fact, the SEC and CFTC have looked at one instance and neither agency has come up with any kind of charges.

Now with this information sharing agreement that is just starting, we are going to be able to police it and to find out if this is a real problem or not, but that is a very new system. And it has nothing to do with stopping at the border.

Senator **Heinz**. Let me ask you about some problems that at least some other people think are real.

The retardation of product innovation as evidenced by the fact that index participations kind of got caught in a legal scuffle. Wasn't that a real problem? Didn't it retard letting a new product, an innovative product, trade on whatever exchange wanted to trade it?

Dr. **Gramm**. Well, there are rules.

Senator **Heinz**. Was that a problem or not?

Dr. **Gramm**. Yes, it was a problem that we tried to address. IP's could be trading. As a matter of fact, let me point out something. The product being sold in Toronto, which is called an IP's product, is similar to the New York Stock Exchange product. It is a basket product. It is a security. There is an underlying asset that is being traded there. The United States IP's product had nothing to do with capital formation.

Senator **Heinz**. Look, I don't think anybody down there is in the business of passing judgment on products. You're about to say it isn't this and it isn't that. I think that's irrelevant.

Dr. GRAMM. I'm not passing judgment.

Senator HEINZ. It is not relevant whether a product is for capital formation or for liquidity or whatever. That's for the market to decide, not the regulators.

Now if I sound like Senator Gramm, I apologize to you because you have to listen to him more than we do.

Dr. GRAMM. It's the law that decides that. You are right.

Senator HEINZ. With respect to driving business offshore, at least one of our panelists has said that what's happening with commodity swaps. There is a very healthy business that is taking place in London in swaps that could be done in either New York or Chicago but isn't being done. That is also a consequence of the laws we've got on the books right now.

Dr. GRAMM. I would dispute that.

Senator HEINZ. OK. Good.

Dr. GRAMM. Last year the CFTC issued a policy statement that established some regulatory certainty in the area of commodity swaps. There was uncertainty because people thought that commodity swaps might be a problem not only because of the Commodity Exchange Act but also because of the banking regulatory authorities.

We at the commission worked hard and put out a policy statement saying that there is a safe harbor—that we would not regulate these swaps as futures and they would therefore not be required to adhere to the exchange trading requirement for futures. But there is not——

Senator HEINZ. Suppose the courts get involved in that one. Suppose someone goes to court and says there's an element of futurity here. What's going to happen?

Dr. GRAMM. I think that what the Commission did on the commodity swaps issue is an example of good Government. That is, we worked within the context of the law to carry out our statute—protecting the public, etc., but also allowing institutions and firms to trade these products. That's what our policy statement did. Now whether or not it will stand a litigation test, I don't know. But as of this time those products are trading here and there has not been litigation. There was some trading of those products in London—a limited amount—but I want you to know that there is litigation even in London at this point in time which could possibly send more of that business back over here.

There are uncertainties. We are not going to avoid uncertainties.

Senator HEINZ. Thank you very much.

I want to ask everybody for—kind of a bottom line. You four are proof of something that President Kennedy said when he was asked what kind of advice he got from the brilliant cabinet that he had assembled and he apparently answered, "Disagreement."

Yet the Working Group has to work in order for our markets to be properly sound and secure.

My question is, since there are the disagreements we've heard today on these intermarket issues, notably regulation of prudential margins and hybrid products, should the courts or Congress have to resolve each dispute as it arises? If not, how do you suggest that the Working Group work to resolve these disputes rather than to have them go unresolved? Does anybody want to take a crack at that. I see Bob Glauber kind of being the most uncomfortable in his chair.

Mr. GLAUBER. He's shifting nervously in his seat. Having done that, let me respond.

I think that the Working Group was never, as I understand it, envisioned as more than a place where this group of regulators could come together and exchange views, refine their views, and on some issues reach a consensus.

What I would point out to you, Senator Heinz, is that on some issues the Working Group has been quite successful at reaching toward consensus. There were issues that lay behind the SEC's Market Reform Act, S. 648, where I think the Working Group that was a useful forum for our exchanging ideas and coming to agreement which allowed, for example, the Treasury to back that legislation very strongly.

I don't think it was ever envisioned that the Working Group should be a rule-making body, that it should issue regulations and hence speak with a single voice. I think that's too much to ask of it. I think it has been useful and I think it should continue to operate as a forum for discussion and for an exchange of views.

Senator HEINZ. So you don't want Congress to say, "Congratulations, you are now a dispute settlement group." What you're really saying is, "Congress, you'd better do your best to settle these disputes by doing your job as legislators. Otherwise, you do leave it to the courts and that is the last thing that honorable Americans should want to do."

Mr. GLAUBER. I would agree with that. I don't think the courts should be where this is settled.

Senator HEINZ. Senator Dodd and I were just saying, although none of us really like the idea of getting into the middle of what can be and at times clearly is a turf war, that, unfortunately, what everybody seems to say is that nobody down there is anxious to make these decisions collectively, unilaterally, or any other way, and we're going to have to step in. I suppose that means we're just going to have to find a means to have our colleagues express their will on these issues one way or another and I guess that's what I take away from this hearing, Mr. Chairman.

Senator DODD. Thank you very much.

We've kept you a long time and I'll just ask a sort of wrap-up question if I could and then submit any additional questions. You've been very patient and I appreciate it immensely. It's been very interesting to hear your views.

Mr. Glauber, let me pose it to you because you raised it most explicitly. Let me quote your testimony on page 12. You say, "We believe the minimum course of action would be to unify regulation of stocks, stock options and stock index futures under the agency with the greatest overall expertise in the combination of these products, the SEC."

You then go on to say, "If this minimum approach cannot be accomplished soon, it seems very likely that we would be forced to adopt a complete merger approach at a later time in response to new major market disruptions."

I just want to ask you very bluntly and then ask the rest of the panel to respond—just what, in your view, are the consequences of our failure, a congressional failure, to act soon, and what dangers do you see? I'd like to ask the same question of each of your copanelists, whether or not they see the potential for a major market disruption on the horizon. If not taking the action that's being recommended at least by Treasury and the SEC and to some degree the Federal Reserve and, as I understand you, Wendy, just not taking any action at all, what other things would you be recommending we do? We'll start with you, Bob.

Mr. **Glauber**. Mr. Chairman, major market declines have happened in the past from time-to-time and I believe they will happen in the future.

I think one danger is that when such a decline occurs, if we have not made progress, there is the potential that that decline will be accelerated in its violence, in its speed, in its severity.

The second consequence of not taking action and taking action soon I think is that we will continue to have these roadblocks to innovation which is the lifeblood of the competitive position of our markets.

So I think the Treasury believes, Secretary Brady believes that we need to take action and take it soon and we've outlined the alternatives that we think are reasonable.

Senator **Dodd**. Mr. Breeden.

Mr. **Breeden**. Mr. Chairman, first of all, I don't want to overplay this situation and create a sense of undue alarm. We have strong capital markets. We have a strong system of regulation. We saw in the recent Drexel case that it's strong enough to accommodate the failure of a major firm, and it's important for the public to have the confidence to participate in those markets, both on a short-term basis and on a long-term basis.

So I don't want to create the suggestion that the current system is completely untenable. We will work as hard as necessary to try to make it work. But what we do have is a situation where a number of specific problems have developed and we're not talking about 1981 and 1982. We're talking about what we've learned since then. What we've learned since then is that there are some specific problems that we can cure and still have the best equity, the best futures, and the best agricultural markets in the world. Indeed we can make them even better.

I think everyone has to realize, as Bob Blauber suggests, that markets swing. They go up. They go down. And the objective systemically is to make sure that, when they swing down, they don't get to a point where the system is unable to handle the pressures put on it—that the market doesn't then break through the bottom and go into a free fall.

The fact that on October 13 and 16, 1989, we had about $1.3 billion in margin calls going on in the Chicago markets created more risks than we would have had if we had gone into those events with margins at 10 or 12 or 15 percent and had the flexibility to ease margins off rather than tightening them when we were in the teeth of the gale.

My concern is that the probability of a serious problem becoming a much more serious problem is slightly higher if we don't address these issues. We can put some reinforcing in the bridge, and that's a good thing. Certainly, in the competitiveness area, the inevitable result, if we do not change the exclusivity clause, will be a steady loss of jobs in the United States and the export of those jobs to Europe and other countries.

Senator **Dodd**. Mr. Chairman.

Mr. **Greenspan**. Let me start by agreeing on the exclusivity question which I think is clearly a problem which can and should be resolved as expeditiously as possible.

On the issue of the change in structure which I would personally recommend, which is not a huge change but I think a desirable one, were that not done, I do not think that we leave the structure in total at risk. I think it will be more difficult to resolve certain issues, but I would scarcely want to argue that action is mandatory because if action fails that the present system would be put in jeopardy. I don't believe that.

I think that if there is a major market reaction, it is likely to occur with or without changes that we're talking about, and I'm not certain the extent to which the types of changes we're talking about would make all that much of substantial difference in how the particular market break worked its way through the system.

Senator **Dodd**. Thank you, Mr. Chairman.

Dr. Gramm.

Dr. **Gramm**. I would agree with Chairman Greenspan that the lack of a jurisdictional change will not have any impact or create any jeopardy in the markets.

Let me be quite clear on this. I am not saying that the agencies are not doing anything. I do believe we should be working together to deal with the real intermarket issues that the Working Group was created to address. Intermarket issues that deal with clearing and settlement, and coordination of circuit breakers, rather than the perennial jurisdictional desire of the SEC to regulate stock index futures once they were developed.

The case simply has not been made for any change in jurisdiction and I'd say, let us not leave here with the impression that the SEC and the CFTC do not work together on a regular basis on other issues like Drexel, for example.

Senator **Dodd**. I didn't seat you at either end of the table because you don't get along.

Dr. **Gramm**. But we do work together and I think Drexel is a good example of that. But let us not suggest that disaster would occur. I think that is an irresponsible suggestion.

Senator **Dodd**. Well, again, I thank all four of you. This has been a very worthwhile hearing this morning. We will continue to stay in touch with you on this as we move forward, seeking your advice and counsel as we wrestle with these problems.

The subcommittee stands adjourned until further call of the chair.

[Whereupon, at 12:50 p.m., the hearing was adjourned.]

[Response to written questions and additional material supplied for this record follows:]

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

June 4, 1990

Dear Mr. Chairman:

Enclosed are my responses to questions from Senators Sasser and Sanford in connection with the Committee's March 29 hearing on SEC-CFTC jurisdiction.

We are hopeful that the crucial issue of regulatory fragmentation can be addressed in this session of Congress. The March 29 hearing was a very constructive step in that direction.

Sincerely,

Bob

Robert R. Glauber
Under Secretary for Finance

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, DC 20510

Enclosures

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM ROBERT R. GLAUBER

Q.1. Volatility in the securities markets and the flight of the small investor are problems we all want to address. With fewer individuals owning stock, we have fewer long-term owners. And a lack of long-term ownership makes our corporations very short-sighted.

There are any number of causes of this volatility. It may be that trading in stock futures is a leading cause. However, it may be simpler than that. It may be that we have volatility because much more stock is owned by institutions. And these institutions tend to turn over their ownership faster.

Senator Sanford and I have introduced a bill called the "Long-Term Investment, Competitiveness and Corporate Takeover Reform Act of 1990." The bill contains an anti-churning rule called the "short-short" test. Under the short-short test, mutual funds are prohibited from earning more than 30 percent of their income from stocks held less than three months. Our bill would extend this rule to pension funds; the logic being that all the big players should be under the same rules.

Our provision amends ERISA, it is not a tax. What do you think of this approach to the volatility and the short-term outlook question?

A.1. I agree that excessive short-term trading can have a negative impact on our corporations if this activity indeed forces corporate managers to focus too much attention on near term results. Unfortunately, disinterested long-term investors are no more likely to promote long-term strategic behavior by corporations.

Many who look at this issue conclude the goal is to provide an environment where shareholders make a commitment to hold equities for longer periods of time to give corporations more freedom to pursue strategic initiatives. In exchange for that commitment, though, shareholders need greater assurance that they can hold management accountable for their use of corporate resources.

In my opinion, the above objectives can best be achieved by reforming aspects of corporate governance to encourage shareholders to behave more like owners than traders.

Extension of the short-short test to pension funds, depending on details of the proposal and the sanctions that would be imposed by failure of the test, is also worth looking at. The 30 percent limit is probably high enough to permit funds to earn short term gains which are generated in the ordinary course of business without paying tax.

However, this proposal has potential drawbacks. Because the test is applied to gross income before investment losses, a fund could fail the test and thus be subject to potentially severe sanctions even if it is not deliberately "churning" its assets. For example, in the event of a stock market crash like that of October 1987, a hedging transaction designed to insure against such events could result in large offsetting gains and losses. Because the short-short test does not count losses, the large offsetting gains could cause a test failure if the asset sales fall under the three month limit. By penalizing funds for using futures and options markets to insure against stock market risk, the short-short rule would discourage such investment strategies. This would limit the ability of pension fund investors to follow reasonable low risk investment strategies, and thus possibly lower the liquidity and efficiency of financial options and futures markets.

Q.2. I keep hearing that most of the world's developed trading markets have one regulator of stocks and futures.

a.) But is there a very developed futures market anywhere else, so is this even a relevant point?

b.) Does the fact that we have two regulators cause real problems in terms of cooperation with other regulators?

A.2. Global markets are growing quickly, and new markets are developing all the time. In 1989, for example, 164 million financial futures contracts were traded in the U.S. (up 18% from 1988), compared with 24 million on the LIFFE in London (up 53% from 1988), 26 million on the MATIF in Paris (up 58% from 1988), and 5.4 million on the Osaka Securities Exchange (up 124% from 1988). The Tokyo International Financial Futures Exchange traded 4.6 million contracts in 1989, its first year of business. Annual figures for the Tokyo Stock Exchange were not immediately available, but in December 1989 1.86 million contracts were traded on yen government bonds and the TOPIX stock index. Together with the United States, the markets in Japan, the U.K., and France account for 90 percent of global futures trading.

The fact that we have two regulators causes several problems in the context of globalization. First, it is more difficult for the United States Government to speak to other governments with a unified and consistent voice on securities and futures issues. Second, it is more difficult to coordinate U.S. regulatory policy with that of other countries when we have two separate regulators and the countries with the most developed markets -- Japan, the U.K. and France -- have unified regulation. Third, and most important, it results in our markets being more susceptible to major intermarket disruptions, less efficient, and therefore less competitive than they would be if we could address intermarket problems with a more unified regulatory approach.

Q.3. Is there a practical difference between margins on stock and futures? If there is, why does it matter if they're set at different levels?

A.3. Margins on stocks and futures are different in some respects due to differences in the extent of daily marking to market, different settlement periods, and the like. But margin requirements on stock and futures share a fundamental characteristic -- they control leverage, and leverage determines how much securities or futures can be bought or sold with a given amount of collateral.

Leverage in the futures markets has several consequences. It obviously affects the prudential interest of the clearinghouse. But if the clearinghouse sets margin too low for its own prudential purposes, as we believe they have in some cases, there is a systemic risk that a failure of one clearinghouse could cause a chain reaction that destabilizes the system. That systemic risk, which really is a prudential risk to the public, goes beyond the private interest of the individual clearinghouse. This is one very important reason why we believe some mechanism for governmental oversight of futures margins is needed. Moreover, inconsistent margins in two segments of what is really "one market" can, we believe, contribute to episodic periods of market wide disruption. These disruptive episodes erode investor confidence and ultimately can affect the cost and availability of capital. Such periods of market disruption also put inordinate strain on the clearance and settlement process and thus, engender systemic risks as well.

The margins on stocks, stock options, and stock index futures should be harmonized, not equalized, so that the leverage effects in the "one market" are consistent. To ensure consistency, and given that futures margins have a public purpose, there also should be, we believe, a unified system of federal oversight of margins on stocks, stock options, and stock index futures.

Q.4. One of the findings of the Brady Commission was that speculation in corporate takeover stocks had fed the run up in the stock market prior to the crash of October 1987. I also understand that the collapse of negotiations for the buyout of United Airlines contributed to the 200 point one day drop in October.

What role does speculation by large traders in corporate takeovers and leveraged buyouts play in causing volatility in the market?

A.4. The key point is that in October 1989 an event that affected a single stock, UAL, or at most airline industry stocks, quickly spread throughout the entire market and forced all stock prices down precipitously. Because takeover players also work through futures markets, which wash back into the equity markets, the episode underscores the vulnerability of the "one market" to major market disruptions that can arise from uncoordinated and inconsistent mechanisms.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM
ROBERT R. GLAUBER

Q.1. You note in your testimony that the broadest solution would be to merge the SEC and the CFTC. While you state that a merger is the broadest solution, does the Treasury believe it is the best solution?

A.1. Merger of the CFTC and SEC is one of the solutions Congress should consider seriously. However, a merger would involve major regulatory changes that are more than is necessary to address the problems we believe require immediate attention. Instead, we support a less sweeping approach that would only unify regulation of the "one market" of stocks, stock options, and stock index futures under the SEC, the agency with the greatest expertise in the combination of these products. We believe this is the most appropriate approach for addressing regulatory fragmentation with the least disturbance to and best protection for the futures markets.

Q.3. One of the issues that is often raised in looking at the problem before us today is that of volatility in the market. While each of you has touched on the issue of volatility and given various explanations for some of the current volatility, I am afraid that a good deal of it comes down to a shift in the market away from individual investors in single equities to institutional investors, some of which have very high turnovers in their portfolios.

Indeed, a recent study noted that the 13 largest pension funds on average turned over in excess of 60 percent of their portfolio assets every year and that 20 percent of the largest institutional investors turned over their entire portfolio each year. Studies by the Department of Labor indicate that pension funds returns are reduced as a result of transactions costs associated with high turnover rates.

In response to this problem, our colleague Senator Kassebaum introduced a bill to tax short-term gains by pension funds. Senator Sasser and I proposed an alternative approach -- applying the "short-short" rule that applies now to mutual funds to pension funds as well. This rule provides that funds cannot make more than 30% of their profit from stocks held for less than 3 months.

Could you comment on this issue. Are these turnover rates troubling? Are they adding to volatility in the markets? Do you have any particular approach to address the problem? Would you favor the application of the "short-short" rule to pension funds?

A.3. Excessive short-term trading can have a negative impact on our corporations if this activity indeed forces corporate managers to focus too much attention on near term results.

Unfortunately, disinterested long-term investors are no more helpful in promoting long-term strategic behavior by corporations.

Many who look at this issue conclude the goal is to provide an environment where shareholders make a commitment to hold equities for longer periods of time to give corporations more freedom to pursue strategic initiatives. In exchange for that commitment, though, shareholders need greater assurance that they can hold management accountable for their use of corporate resources.

In my opinion, the above objectives can best be achieved by reforming aspects of corporate governance to encourage shareholders to behave more like owners than traders.

Extension of the short-short test to pension funds, depending on details of the proposal and the sanctions that would be imposed by failure of the test, is also worth looking at. The 30 percent limit is probably high enough to permit funds to earn short term gains which are generated in the ordinary course of business without paying tax.

However, this proposal has potential drawbacks. Because the test is applied to gross income before investment losses, a fund could fail the test and thus be subject to potentially severe sanctions even if it is not deliberately "churning" its assets. For example, in the event of a stock market crash like that of October 1987, a hedging transaction designed to insure against such events could result in large offsetting gains and losses. Because the short-short test does not count losses, the large offsetting gains could cause a test failure if the asset sales fall under the three month limit. By penalizing funds for using futures and options markets to insure against stock market risk, the short-short rule would discourage such investment strategies. This would limit the ability of pension fund investors to follow reasonable low risk investment strategies, and thus possibly lower the liquidity and efficiency of financial options and futures markets.

Q.4. Other suggestions have been made that short-selling may be part of the problem as well. Hearings were held on the House side to discuss a proposal to create a reverse 13(d) which would require short sellers with a short position exceeding 5 percent of a company's outstanding shares to file a public report with the SEC of their position.

What do you think of that proposal? Is short-selling part of the problem?

A.4. The 13(d) proposal would not go to the heart of the problem, which is the inconsistency of having an uptick requirement for short sales of stock but no comparable requirement for stock index futures (short sales of futures are not possible). There is no easy answer to this problem, but I believe it is one of several inconsistencies in intermarket mechanisms that are contributing to excess volatility in the markets. The best way to resolve these critical intermarket issues would be to adopt a more unified regulatory structure. In the meantime, this issue is appropriate for consideration by the Working Group on Financial Markets.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

April 4, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am pleased to enclose my responses to the questions Senator Sasser submitted for the record of the hearing on March 29 before the Securities Subcommittee on SEC/CFTC jurisdiction and margin.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Chairman Greenspan subsequently submitted the following in response to written questions from Senator Sasser in connection with the hearing held on March 29, 1990.

Q.1. Volatility in the securities markets and the flight of the small investor are problems we all want to address. With fewer individuals owning stock, we have fewer long-term owners. And a lack of long-term ownership makes our corporations very short-sighted.

There are any number of causes of this volatility. It may be that trading in stock futures is a leading cause. However, it may be simpler than that. It may be that we have volatility because much more stock is owned by institutions. And these institutions tend to turn over their ownership faster.

Senator Sanford and I have introduced a bill called the "Long-Term Investment, Competitiveness and Corporate Takeover Reform Act of 1990." The bill contains an anti-churning rule called the "short-short" test. Under the short-short test, mutual funds are prohibited from earning more than 30 percent of their income from stocks held less than three months. Our bill would extend this rule to pension funds; the logic being that all the big players should be under the same rules.

Our provision amends ERISA, it is not a tax. What do you think of this approach to the volatility and the short-term outlook question?

A.1. I would proceed cautiously in considering legislation of the sort you outline. I can readily see how the concentration of ownership of shares in institutional hands **could** lead to greater volatility, but **could** is not the same thing as **does**. I have described in congressional testimony how, in an era of instant global communication, institutional traders might attempt to beat each other to the punch in response to new information--creating a herd movement that may temporarily push prices beyond "correct" levels. But one must recognize, too, the possibility that active institutional trading may provide liquidity to the market that actually may tend to reduce volatility. The balance of these forces is not clearcut.

One must also consider whether restraints on short-term trading might be inconsistent with the ability of institutions to adjust their portfolios so as to serve the interests of their investors. The fortunes of companies do change--as do general economic and financial conditions--and institutions may have legitimate grounds for quickly reversing investment decisions made just a short time earlier. For this reason, artificial impediments to trading ought to be approached with care.

Q.2. I keep hearing that most of the world's developed trading markets have one regulator of stocks and futures.

a) But is there a very developed futures market anywhere else, so is this even a relevant point?

b) Does the fact that we have two regulators cause real problems in terms of cooperation with other regulators?

A.2.a. Although the U.S. futures exchanges are leaders, organized futures exchanges are developing elsewhere, in Europe and in Asia. Moreover, arrangements for international connections of exchanges are emerging. So, regulators in other countries do have an interest in such markets, and there is reason for cooperative effort among regulators internationally.

A.2.b. The multiplicity of regulators of securities and futures markets does present a complexity, but not an absolute impediment, for international coordination efforts.

Q.3. Is there a practical difference between margins on stock and futures? If there is, why does it matter if they're set at different levels?

A.3. Yes, there are practical differences, based on the differences in the nature of the instruments, the margining procedures, and the clearing and settlement systems. And because of the differences, margins need not, and probably should not, be set at the same levels for prudential purposes.

Q.4. One of the findings of the Brady Commission was that speculation in corporate takeover stocks had fed the run up in the stock market prior to the crash of October 1987. I also understand that the collapse of negotiations for the buyout of United Airlines contributed to the 200 point one-day drop in October.

What role does speculation by large traders in corporate takeovers and leveraged buyouts play in causing volatility in the market?

A.4. Obviously, one can point to specific cases in which the "volatility" of particular securities prices was directly related to speculation regarding takeovers. But, of course, volatility that reflects simply the movement of share prices to levels that incorporate new information regarding the values of corporate assets is healthy--i.e., it is desirable that share prices reflect as rapidly as possible the inherent value of companies. And one might view some of the "large trader" activity in these events as useful risk-transfer, particularly in the case of risk arbitrage in which arbitrageurs take positions after takeover announcements, providing shareholders who do not wish to take the risk that a deal will not be consummated an opportunity to sell their stock at a profit.

In the end, I don't think there is a basis for dissecting the market activity and measuring the contribution of "speculation by large traders" to general market volatility.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

April 16, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am pleased to enclose my responses to the questions Senator Sanford submitted for the record of the hearing on March 29 before the Securities Subcommittee on SEC/CFTC jurisdiction and margin.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Chairman Greenspan subsequently submitted the following in response to written questions from Senator Sanford in connection with the hearing held on March 29, 1990.

Q.3. For the panel: One of the issues that is often raised in looking at the problem before us today is that of volatility in the market. While each of you has touched on the issue of volatility and given various explanations for some of the current volatility, I am afraid that a good deal of it comes down to a shift in the market away from individual investors in single equities to institutional investors, some of which have very high turnovers in their portfolios.

Indeed, a recent study noted that the 13 largest pension funds on average turned over in excess of 60 percent of their portfolio assets every year and that 20 percent of the largest institutional investors turned over their entire portfolio each year. Studies by the Department of Labor indicate that pension funds returns are reduced as a result of transactions costs associated with high turnover rates.

In response to this problem, our colleague Senator Kassebaum introduced a bill to tax short-term gains by pension funds. Senator Sasser and I proposed an alternative approach--applying the "short-short" rule that applies now to mutual funds to pension funds as well. This rule provides that funds cannot make more than 30% of their profit from stocks held for less than 3 months.

Could you comment on this issue. Are these turnover rates troubling? Are they adding to volatility in the markets? Do you have any particular approach to address the problem? Would you favor the application of the "short-short" rule to pension funds?

A.3. The turnover rates can be viewed from a number of perspectives. One of these is whether active trading, with the attendant transactions costs, results in better investment performance than a "buy and hold" strategy; I suspect that the experience varies considerably across institutions and time periods. But, I gather that your focus in this instance is really more on the health of the equities markets and the issue of whether short-term trading adds significantly to price volatility. As I noted in response to the related question raised by Senator Sasser, while it is conceivable that such trading could increase volatility, it is not at all clear that it actually does. It is possible that the trading activity even enhances the efficiency of securities pricing and provides beneficial liquidity to the market.

Under the circumstances, I am hesitant at this point to categorize the phenomena you note as a "problem", and I would counsel caution in considering the creation of artificial impediments to trading.

Q.4. Other suggestions have been made that short-selling may be part of the problem as well. Hearings were held on the House side to discuss a proposal to create a reverse 13(d) which would require short sellers with a short position exceeding 5 percent of a company's outstanding shares to file a public report with the SEC of their position. What do you think of that proposal? Is short-selling part of the problem?

A.4. I doubt that short-selling of individual stocks is a major factor in the general market volatility that is the focus of your concerns. Thus, from this particular perspective, I don't see the need for the disclosure requirement.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM WENDY L. GRAMM

Q.1. Volatility in the securities markets and the flight of the small investor are problems we all want to address. With fewer individuals owning stock, we have fewer long-term owners. And a lack of long-term ownership makes our corporations very short-sighted.

There are any number of causes of this volatility. It may be that trading in stock futures is a leading cause. However, it may be simpler than that. It may be that we have volatility because much more stock is owned by institutions. And these institutions tend to turn over their ownership faster.

Senator Sanford and I have introduced a bill called the "Long-Term Investment, Competitiveness and Corporate Takeover Reform Act of 1990." The bill contains an anti-churning rule called the "short-short" test. Under the "short-short" test, mutual funds are prohibited from earning more than 30 percent of their income from stocks held less than three months. Our bill would extend this rule to pension funds; the logic being that all the big players should be under the same rules.

Our provision amends ERISA, it is not a tax. What do you think of this approach to the volatility and the short-term outlook question?

A.1. Since the 1960s and 1970s individual investors have shifted their asset holdings away from direct equity investments. As a result, institutional investors, such as pension funds and insurance companies, are now dominant players in today's equity markets. The fact is that institutional holdings account for 35 percent of all U. S. equity holdings, up from 13 percent in 1965, while household holdings represent 57 percent of all U. S. equity holdings, down from 84 percent in 1965.

However, between 1982 and 1987, annual equity turnover rate for pension funds has remained in the 50- to 60-percent rate. Therefore, it appears that active management of a portfolio has been a standard practice over the past several years.

It is also worth noting that a recent paper by William Schwert in the Journal of Finance, 1989, concludes the level of volatility in securities prices has not increased when viewed over the long term. Recent large absolute price movements overstate the volatility of returns, since overall stock prices have risen.

The Commission favors establishing clear guidelines that enable the markets to discover prices in a competitive and fair manner. The "short-short" rule can restrict the available range of investment options for pension fund managers. Such a rule may simply delay the readjustment period for portfolios, during which time the erosion in principal can significantly reduce the returns. Furthermore, the investment climate today is global in nature and quite sensitive to new information. This proposal, which taxes capital gains incurred in less than 90 days, can hamper or delay a judicious reaction to an adverse event. So, we are not convinced that this proposal may achieve its desired goal.

Q.2. I keep hearing that most of the world's developed trading markets have one regulator of stocks and futures.

a. But is there a very developed futures market anywhere else, so is this even a relevant point?

A.2.a. There are no foreign futures exchanges approaching the size of the largest U.S. futures exchanges, although several are growing very rapidly. The U.S. accounts for about 70 percent of world futures volume. In 1989 the Chicago Board of Trade had an annual futures volume of 112 million contracts, the Chicago Mercantile Exchange volume was 87 million contracts, and the New York Mercantile Exchange volume was over 32 million contracts. In contrast, the largest foreign futures markets in 1989 were the MATIF in France and LIFFE in England, with annual volumes of 26 and 24 million contracts, respectively.

A careful examination of the regulatory structure of different countries reveals a wide disparity of regulatory approaches across countries and a substantial degree of regulatory fragmentation within countries, particularly in those countries with the largest futures markets. For example:

- In Japan, three ministries, the Ministry of Finance, the Ministry of International Trade and Industry, and the Ministry of Agriculture, Forestry, and Fisheries administer three statutes which govern the Japanese securities and futures markets.

- In the United Kingdom, responsibility for regulating futures and securities business is vested in the Department of Trade and Industry, the Bank of England, the Securities and Investments Board, and specialized self-regulatory organizations such as the Association of Futures Brokers and Dealers and The Securities Association. Regulatory overlap is addressed by ensuring coordination and cooperation among regulators.

- In France, numerous laws govern futures and securities transactions and are administered by the French Ministry of Finance, the Commission des Operations de Bourse, an independent regulatory agency, and two legislatively created bodies, the Conseil de Marche a Terme (CMT) and the Counseil des Bourses de Valeurs (CBV). The CMT and CBV have primary responsibility for supervising the activities of and transactions on the futures and securities markets, respectively, and have unique rules and regulations applicable to the markets which they regulate. The Bank of France also has relevant regulatory responsibilities.

Q.2.b. Does the fact that we have two regulators cause real problems in terms of cooperation with other regulators?

A.2.b. The existence of separate regulators for the securities and futures markets does not cause any real problems in terms of cooperation with other regulators. The CFTC routinely cooperates with the Federal Reserve Board, the SEC, the Department of the Treasury, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and other federal regulators in areas of common concern. For example, the CFTC routinely shares large trader data with the SEC to facilitate reviews of market activity and coordinates oversight activities with the SEC with respect to firms dually registered as futures commission merchants and securities broker-dealers. The Commission's recent regulatory initiatives concerning hybrid instruments were developed with the benefit of extensive consultation with the SEC, Federal Reserve Board, Comptroller of the Currency, and the Department of the Treasury.

Similarly, neither agency has impeded the ability of the other to cooperate with foreign regulators and both have done so extensively on a formal and informal basis. In practice, cooperation with foreign regulators tends to involve the participation of multiple foreign regulators and to reflect market-specific concerns relating to futures markets, which may differ from those applicable to securities markets. The fact that neither agency has impaired the ability of the other to negotiate or otherwise deal with foreign regulatory authorities is reflected in the numerous information-sharing agreements entered into by the CFTC and the SEC with foreign regulators. A list of information-sharing agreements entered into by the CFTC is attached.

INFORMATION-SHARING ARRANGEMENTS TO WHICH THE CFTC IS A PARTY

- Memorandum of Understanding between the Department of Trade and Industry, the Securities and Exchange Commission and the Commodity Futures Trading Commission, signed on September 23, 1986, and the supplemental Memorandum thereto signed on November 22, 1988 adding the Securities and Investments Board as a signatory to the agreement (hereinafter "UK/US MOU").

- Financial Information Sharing Memorandum of Understanding between the Commodity Futures Trading Commission, the Securities and Investments Board and certain United States and United Kingdom self-regulatory organizations, signed on September 1, 1988.

- Cooperative arrangements exist for information sharing on matters related to implementation of the Commission's foreign futures and options regulations and foreign linkages with:

    - the Australian Attorney General's Office and the National Companies and Securities Commission;

    - the federal government of Canada and two provincial authorities, the Commission des valeurs de mobilieres du Quebec and the Ontario Securities Commission;

    - the Monetary Authority of Singapore; and

    - the United Kingdom, where the existing UK/US MOU was broadened to include the "Side Letter Relating to UK/US MOU" signed on May 15, 1989, by the Commission and the Securities and Investments Board pursuant to which the Commission also has access to information from the Association of Futures Brokers and Dealers, The Securities Association, the Investment Management Regulatory Organisation and the Bank of England.

Q.3. Is there a practical difference between margins on stock and futures? If there is, why does it matter if they're set at different levels?

A.3. Practical differences exist in the function of futures and securities margins and the clearance and settlement systems of the futures and securities markets which warrant different levels of margin between these markets. The futures markets are mechanisms for the transfer of risk, for example, from a party subject to price risk because of its primary manufacturing, farming or financial operations. When a party enters into a futures contract as a hedging mechanism, the party is not purchasing an asset but rather is purchasing price insurance.

Consequently, as the President's Working Group on Financial Markets (Working Group) concluded in its May 1988 report, futures margin levels that are lower than those for individual securities, are nonetheless "prudential" and such transactions do not create greater risk than comparable securities transactions. The Working Group unanimously concluded that "the prudential maintenance margin percentages required for carrying an individual stock should be significantly higher than the percentage margin required for a futures contract on a stock index." Because of the greater volatility of individual stocks as compared to stock indices and the much longer settlement period in the stock market than the futures market (five business days for securities as compared to daily and intra-day futures settlements), stock margins must be significantly higher than futures margins to provide the same level of protection.

The futures margining system is designed to measure the risk involved in each transaction and establish an appropriate margin level based upon market volatility and the type of trading involved in the transaction. This system requires that both sides to a trade, the long and the short, make margin deposits and that all losses and gains on positions be paid daily such that, at settlement, no debt on any futures contract remains outstanding.

In futures trading, margin refers to funds paid as a performance bond by each party to the contract to secure the mutual promises represented by the contract. Futures margin does not represent an extension of credit or result in the passage of title to the commodity, which takes place only in those infrequent instances where a party takes delivery on the futures contract and pays the full value of the commodity. The percentage of futures contracts settled by delivery or cash settlement was less than one percent of all futures contracts traded in each year in the 1980s.

In securities trading, "margin" refers to the minimum amount that a purchaser of shares of stock must deposit with his broker so that title to those shares passes to the purchaser. The remaining balance owed by the purchaser is borrowed, usually from the broker, and the stock certificates are normally left on deposit with the broker to secure the unpaid balance due on the loan. Securities margins are paid only by purchasers and short sellers, represent part of the price of the security, and are based on an infrequently revised determination of the loan value of the securities purchased. The last change in initial margin for securities transactions was made by the Federal Reserve in 1974. Futures margins, which are governed by variable risk and volatility factors, will be changed several times a year in an active contract.

Differences in the amount of futures and securities margin required to be posted based on the different functions of futures and securities margin do not necessarily equate to differences in the degree of "leverage" or risk entailed in the transactions. As the Working Group noted, differences in the nature of the futures and securities clearance and settlement systems render different levels of margin "prudential" in those markets. Also, the degree of "leverage" involved in a futures transaction in a stock index or other cash commodity underlying the contract depends upon the relationship between the futures transaction and the cash positions of the transacting parties. For example, 70 percent of the open interest in the CME Standard and Poor's 500 index futures market on October 19, 1987 was held by reporting commercial traders whose positions normally are taken in conjunction with, rather than as substitutes for, a cash market position.

Q.4. One of the findings of the Brady Commission was that speculation in corporate takeover stocks had fed the run-up in the stock market prior to the crash of October 1987. I also understand that the collapse of negotiations for the buyout of United Airlines contributed to the 200-point one-day drop in October.

What role does speculation by large traders in corporate takeovers and leveraged buyouts play in causing volatility in the market?

A.4. We do not believe anyone knows the answer to this important question, because it has not been the focal point of most of the studies of stock market volatility. Although the CFTC has a large trader reporting system that enables us to determine quickly who the largest traders were in any stock index futures market, the SEC has no such system as it relates to the individual securities under its jurisdiction. When the SEC studies stock market volatility, it tends to concentrate on program trading, which generally accounts for less than 10 percent of total stock volume, rather than identifying the largest traders in key individual stocks and assessing the rationale for and impact of those activities. On October 13, 1989, the collapse of the negotiated buyout of United Airlines, and the implications of that event on other take-over targets and companies financed heavily by junk bonds, at least triggered the price drop that day. We hope the SEC's ongoing examination of that day's stock trading will address this question.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM
WENDY L. GRAMM

Q.2. The argument that changes in or increases in our margin requirements could force futures trading overseas presupposes, to some extent, that margins in overseas markets are currently the same as or less than U.S. margins. Is this the case? What are the margins on futures in overseas markets and how do they relate to the U.S. Margins?

A.2. Margin requirements on overseas markets are currently the same as, or less than, margin requirements on United States markets for similar products. As the attached Exhibit A indicates, in late March, 1990 the initial speculative margin levels on stock index futures contracts traded on foreign exchanges, expressed as a percent of contract value, were at or below 9.1 percent. During the same period, initial speculative margin levels for stock index futures contracts traded on United States exchanges, with one exception, were all above 9.1 percent.

With respect to non-stock index futures contracts which are traded on both United States and foreign markets, the attached Exhibit B indicates that initial speculative margin levels for those contracts in late March, 1990 were generally comparable.

Exhibit A

Initial Speculative Margin Levels on Stock Index Futures Contracts as of March 1990

Jurisdiction	Exchange	Contract	Margin Requirement
Australia	Sydney Futures Exchange	All Ordinaries	4.80%
Canada	Toronto Futures Exchange	35 Index	9.10%
France	Marche a Terme International de France	CAC 40 Index	7.60%
Japan	Osaka Securities Exchange	Nikkei Stock Average	9.00%
	Tokyo Stock Exchange ("TSE")	Tokyo Stock Price Index	9.00%
United Kingdom	London International Financial Futures Exchange ("LIFFE")	Financial Times 100 Index	4.40%
United States	Chicago Mercantile Exchange ("CME")	S&P 500	10.32%
	Chicago Board of Trade ("CBT")	MMI Maxi	9.68%
	New York Futures Exchange	NYSE Composite Index	9.67%
	Kansas City Board of Trade	Value Line Average	7.21%

Exhibit B

Initial Speculative Margin Levels on Commonly-Traded Non-Stock Index Futures Contracts as of March 1990

Contract	Jurisdiction	Exchange	Margin Requirement
U.S. T-Bond Contract	United States	CBT	2.890%
	United Kingdom	LIFFE	1.250%
	Japan	TSE	4.500%
Deutschemark	United States	CME	2.390%
	United Kingdom	LIFFE	1.500%
Eurodollar	United States	CME	.007%
	United Kingdom	LIFFE	.075%
	Japan	Tokyo International Financial Futures Exchange ("TIFFE")	.080%
Japanese Yen	United States	CME	2.510%
	United Kingdom	LIFFE	12.520%
	Japan	TIFFE	2.500%
Swiss Franc	United States	CME	3.270%
	United Kingdom	LIFFE	1.520%
British Pound	United States	CME	2.730%
	United Kingdom	LIFFE	3.700%

Q.3. One of the issues that is often raised in looking at the problem before us today is that of volatility in the market. While each of you has touched on the issue of volatility and given various explanations for some of the current volatility, I am afraid that a good deal of it comes down to a shift in the market away from individual investors in single equities to institutional investors, some of which have very high turnovers in their portfolios.

Indeed, a recent study noted that the 13 largest pension funds on average turned over in excess of 60 percent of their portfolio assets every year and that 20 percent of the largest institutional investors turned over their entire portfolio each year. Studies by the Department of Labor indicate that pension funds returns are reduced as a result of transactions costs associated with high turnover rates.

In response to this problem, our colleague, Senator Kassebaum, introduced a bill to tax short-term gains by pension funds. Senator Sasser and I proposed an alternative approach--applying the "short-short" rule that applies now to mutual funds to pension funds as well. This rule provides that funds cannot make more than 30 percent of their profit from stocks held for less than 3 months.

Could you comment on this issue. Are these turnover rates troubling? Are they adding to volatility in the markets? Do you have any particular approach to address the problem? Would you favor the application of the "short-short" rule to pension funds?

A.3. We agree individual investors since the 1960s and 1970s have shifted their asset holdings away from direct equity investments. As a result, institutional investors, such as pension funds and insurance companies, are now dominant players in today's equity markets. The fact is that institutional holdings account for 35 percent of all U.S. equity holdings, up from 13 percent in 1965, while household holdings represent 57 percent of all U.S. equity holdings, down from 84 percent in 1965.

However, between 1982 and 1987, annual equity turnover rate for pension funds has remained in the 50- to 60-percent rate. Therefore, it appears that active management of a portfolio has been a standard practice over the past several years.

It is also worth noting that a recent paper by William Schwert in the Journal of Finance, 1989, concludes the level of volatility in securities prices has not increased when viewed over the long term. Recent large absolute price movements overstate the volatility of returns, since overall stock prices have risen.

We favor establishing clear guidelines that enable the markets to discover prices in a competitive and fair manner. The "short-short" rule can restrict the available range of investment options for pension fund managers. Such a rule may simply delay the readjustment period for portfolios, during which time the erosion in principal can significantly reduce the returns. Furthermore, the investment climate today is global in nature and quite sensitive to new information. This proposal, which taxes capital gains incurred in less than 90 days, can hamper or delay a judicious reaction to an adverse event. So, we are not convinced that this proposal may achieve its desired goal.

Q.4. Other suggestions have been made that short selling may be part of the problem as well. Hearings were held on the House side to discuss a proposal to create a reverse 13(d) which would require short sellers with a short position exceeding 5 percent of a company's outstanding shares to file a public report with the SEC of their position.

What do you think of that proposal? Is short selling part of the problem (of volatility)?

A.4. By its nature, this proposal would apply to the short selling in the cash market of individual securities, rather than an index product which is based on a number of securities (such as a stock index future or option). In that regard, we do not know if short selling of individual equities may cause increased volatility in the prices of those particular issues. However, our studies of stock index futures trading do not provide evidence that short sales in the futures market are the source of increased volatility. Of course, unlike the stock market, every short sale in the futures market entails someone taking a long position of the same size.

Furthermore, you should be aware that futures contracts on individual equity securities are prohibited by the Commodity Exchange Act and thus the proposal would have no application to trading subject to CFTC jurisdiction.

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581

Fowler C. West
Commissioner

(202) 254-8541

April 3, 1990

Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
Senate Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

In response to Senator Gramm's request for my individual views on the issue of whether there should be a jurisdictional change between the CFTC and the SEC, I would say simply that there should be no change. I was given an opportunity to provide input to Chairman Wendy Gramm's statement, which was subsequently reviewed and approved by each Commissioner prior to the Subcommittee's March 29th hearing. I believe the current jurisdictional division between our agencies is appropriate. I see no reason why the differences between us cannot be resolved, but when one agency is attempting a jurisdictional raid on another, cooperation becomes quite difficult. Chairman Breeden obviously wants to expand the jurisdiction of the Commission he heads. I believe it would be unwise to legislate jurisdictional shifts simply because one agency wants to get bigger. I have confidence that Congress will require serious reasons for making any jurisdictional change.

In the past, I have indicated that it might be time to give the CFTC expanded oversight of margins, particularly those on stock index futures. I have also suggested that the current jurisdictional scheme might work more efficiently if Congress were to mandate that jurisdictional differences between our agencies be settled by an inter-agency arbitration panel. However, neither of these items would require a shift of jurisdiction from the CFTC to the SEC.

To summarize, I support the jurisdictional division between the CFTC and the SEC as it stands today. I regret that the SEC's aggressive campaign to take away some of the CFTC's jurisdiction makes it difficult to achieve the kind of cooperation between our agencies which the CFTC has always endorsed.

Sincerely,

Fowler C. West

Fowler C. West
Commissioner

cc: Honorable Phil Gramm

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581

Kalo A. Hineman
Commissioner

(202) 254-6318

April 10, 1990

Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
Senate Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

During the March 29 hearing before the Subcommittee, Senator Gramm asked for the views of the individual SEC and CFTC Commissioner's concerning SEC/CFTC jurisdiction issues. For my part, I fully agree with and support our Chairman's testimony before the Subcommittee, including her statement that shifting some of the CFTC's jurisdiction to the SEC or merging the agencies would not address any of the real issues facing our financial markets today. There is nothing broken that such jurisdictional reshuffling would fix.

I also concur with Chairman Greenspan's written testimony to the effect that: the existing division of regulatory authority has not increased volatility in the securities market nor is it a threat to the capital formation process; there is "no substantial evidence linking margin levels to price volatility in the cash or the index-product markets"; and the concentration of regulatory authority inherent in a merger presents "the risk that bureaucratic inertia in a larger agency could be an impediment to the process of innovation".

Futures markets perform a unique risk-shifting function and they perform that function in exactly the same manner regardless of widely disparate underlying cash markets. From soybeans to silver to stock indexes, from crude oil to Treasury Bonds, the same people trade futures on the same exchange floors subject to a single consistent regulatory system administered by a single regulator. A partial shift of CFTC jurisdiction to the SEC would entail two different regulators running two distinct regulatory programs side-by-side on the same exchange floors -- a prescription for chaos.

The alternative suggested by the proponents of jurisdictional change is a merger of the agencies. That course is of particular concern to me as a farmer and the Commissioner most closely identified with agricultural issues. Agricultural futures markets perform vital hedging and price basing functions for American farmers and agribusinesses. Agriculture has also benefited from innovations fostered by the CFTC -- for example, agricultural options, an entirely new marketing tool, which the CFTC first designated for trading in 1985 and which traded over six million contracts last year. In a merged agency, financial contracts would inevitably be the center of attention. Agricultural futures and options would never be more than an unwanted stepchild and the farmers and agribusinesses who depend on those contracts would suffer accordingly.

Sincerely,

Kalo A. Hineman
Commissioner

cc: Honorable Phil Gramm

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W., WASHINGTON, D.C. 20581

William P. Albrecht
Commissioner

(202) 254-6288

April 10, 1990

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

I am writing in response to Senator Gramm's request for the views of individual commissioners concerning transferring some or all of the jurisdiction of the CFTC to the SEC. My view is the same as that expressed in Chairman Wendy Gramm's statement before your committee: there should be no change.

Since joining the Commission in November, 1988, I have spent a great deal of time considering this issue and analyzing the arguments for changing the current jurisdictional arrangement. I have concluded that none of the proposals for change currently being discussed would contribute to the stability, integrity, or efficiency of either securities or futures markets. On the other hand, there is good reason to believe that transferring some of the CFTC's responsibilities to the SEC or combining the two agencies into one would be likely to have an adverse impact upon domestic financial markets and to put them at a disadvantage internationally.

During the past year I have spent much of my time working on international regulatory issues. In dealing with regulators from a number of countries, I have found that each country has its own unique system which typically involves several different authorities involved in the regulation of futures and securities. The CFTC has a good working relationship with these authorities and has not found that the current jurisdictional arrangement in the United States has caused any problems in bilateral negotiations.

The Honorable Christopher J. Dodd
Page Two

The CFTC and the SEC are members of the International Organization of Securities Commissions (IOSCO) which is the primary forum for multilateral efforts directed toward international regulatory harmonization. Chairman Breeden and I serve on the Technical Committee of IOSCO, the group that coordinates most of the work undertaken by IOSCO, and members of our staffs serve on the Working Parties established by the Technical Committee. I do not believe that the existing jurisdictional lines have hampered our ability to work effectively within IOSCO.

The challenges facing the securities and futures industries and their regulators in the coming decade are immense. They include responding to international competition and harmonizing international regulation. The current regulatory structure in the United States is more likely to enable us to meet these challenges than any alternatives that have been suggested.

Sincerely,

William P. Albrecht

William P. Albrecht

cc: The Honorable Phil Gramm

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581

Robert R. Davis
Commissioner

(202) 254-6354

April 12, 1990

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
Senate Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

I am writing in response to Senator Gramm's request, raised in your subcommittee hearing of March 29, asking for the individual views of commissioners regarding shifts of jurisdiction between the CFTC and the SEC. I observed the hearing first hand, and I am in complete agreement with Chairman Wendy Gramm's statement and her responses to questions from the subcommittee. I fully subscribe to the position Chairman Gramm submitted that "[the] Commodity Futures Trading Commission opposes any change in CFTC jurisdiction, including a shift of jurisdiction for stock index futures, or financial futures, or a merger of the SEC or the CFTC. The Commission does not believe that a change in CFTC jurisdiction will solve any of the real issues our markets face today."

I have spent my entire career working in financial markets as an academic, banker, investment adviser, and regulator. Since 1985, I have chaired the CFTC's Financial Products Advisory Committee, through which the Commission maintains an ongoing dialogue with all segments of the financial marketplace. Because of my background and role at the Commission, I have focused intensively on all financial futures issues, and since October 1987, especially those related to equity index futures.

This scrutiny has uncovered no regulatory shortcoming that is inherently the result of current jurisdictional arrangements. In particular, no enforcement effort has been frustrated, no international agreement has been impeded, and no cash market has been disrupted as a result of regulatory structure. Moreover, results of empirical studies overwhelmingly show that futures trading does not cause price volatility in the underlying cash market. Were this the case, evidence of such volatility would be manifest in bond, Eurodollar, and other financial markets where futures contracts exceed the volume of all equity index futures by a factor of more than eleven.

Although government regulation may be imperfect, I strongly believe that improvements should continue to be pursued along functional lines. No problems have been identified that would be resolved by jurisdictional shifts, and the competitive posture of U.S. financial markets likely would be damaged in the long run by an unnecessary consolidation of regulatory power. It is a painful fact that consolidation in government seldom leads to efficiency, either in government or of markets.

I believe that financial markets are ill served by the current focus on jurisdictional disputes. It is time for the regulators to return to genuinely cooperative efforts designed to safeguard the public and foster competition.

Sincerely,

Robert R. Davis

Robert R. Davis
Commissioner

cc: The Honorable Phil Gramm

THE SEC/CFTC JURISDICTION AND MARGIN

WEDNESDAY, JULY 11, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:04 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Cranston, Dodd, Sarbanes, Dixon, Shelby, Kerry, Bryan, Garn, Heinz, D'Amato, Pressler, Mack, Bond, and Kassebaum.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance today and most especially our witnesses and our very distinguished former colleague, and our opening witness, Tom Eagleton, whom I will introduce just a little bit later.

Today's hearing is a very important one. It's the committee's second hearing this year to consider the current division of regulatory authority between the Securities and Exchange Commission and the Commodities Futures Trading Commission.

When we last considered this matter, the President's Working Group testified about modifying the regulatory jurisdiction of the SEC and the CFTC, but there was no specific legislative proposal before the committee at that time.

Since then, the administration has sent us the Capital Markets Competition, Stability, and Fairness Act of 1990. That legislation is the subject of today's hearing.

The Capital Markets Competition, Stability, and Fairness Act raises issues central to the continuing discussion about the appropriate structure for regulating the financial markets of this country.

The administration and, most specifically, Secretary of the Treasury Brady, have stated that current division of authority between the SEC and the CFTC in their judgment leads to disjointed regulation of the markets governing stocks, stock options, and stock index future, which, it is argued, from one market.

SEC Chairman Breeden has strongly endorsed this view as have many securities firms and the securities exchanges.

In sharp contrast, CFTC Chairwoman Gramm believes that the current regulatory structure has enabled the United States to develop the world's strongest futures markets and that adoption of the Treasury proposal risks the viability of these markets.

The CFTC's position is supported by most of the future exchanges and numerous participants in the futures markets. In addition, several agricultural groups have opposed the proposed legislation fearing that it might result in a weakened CFTC that would be unable to effectively oversee the commodity markets which are so critical to the agricultural community.

Clearly, the proposed legislation raises issues central to our continuing study of financial modernization. The answers to questions such as whether unified supervisory authority is necessarily more efficient than split authority are critical to our entire program of financial reform and therefore, need to be discussed, not just by regulators, but by market users and other participants as well.

What corporations, traders, other users and, ulitmately, the public, find most efficient must be very carefully considered.

Regulatory changes should be made only after taking into account all viewpoints and in the presence of a clear reason for making those changes.

I think it is also important that we look into the issue of margins on stocks and their derivative instruments and I have raised this subject any number of times in previous hearings.

Recently, I saw an advertisement that claimed that during the October 1980, market drop, an investor with $100,000 could have acquired by the use of margin, $200,000 in stocks. And another investor with the same $100,000 could have traded stock futures worth more than $4.4 million.

These numbers, if accurate, raise, I think, disturbing questions about the amount of leverage in the futures markets, compared to the underlying stock markets and the level of risks that may introduce into the system as a whole.

The witnesses at today's hearing are extremely knowledgeable about these issues and they will be introduced in a moment.

I only want to say before making a closing comment how pleased we are to have our former colleague, and certainly my dear friend and the dear friend of many of us, Tom Eagleton, back with us in the Senate today.

He has been missed, even in the caucus lunches much missed. [Laughter.]

Finally, I want to say a word about the conduct of this hearing.

In March of this year, the Securities Subcommittee, chaired by Senator Dodd, held a hearing on the appropriate scope of jurisdiction between the SEC and the CFTC. Senator Dodd and I decided that in light of the importance of this subject that we are discussing today and the fact that the issue is, in a sense, before another committee and, in another sense, before the Senate as a whole, that we ought to conduct this hearing today at the full committee level.

Having said that, this is a matter that I look to Senator Dodd and Senator Heinz as the ranking members, as chairman and ranking member of the Securities Subcommittee, to take the lead in crafting whatever legislative recommendation may be brought forward and presented at the full committee level.

And so I've asked Senator Dodd to chair this full committee hearing today, and also the hearing that will be held this afternoon, and then a subsequent hearing on this subject so that this matter can proceed initially within the reach of the work of that subcommittee.

So Senator Dodd, at this point, let me just yield to you and then I think probably Senator Garn, and then we'll go on down the line.

OPENING STATEMENT OF SENATOR DODD

Senator DODD [presiding]. Thank you very much, Mr. Chairman.

I want to express my gratitude to you for holding these hearings and assisting in putting the program together. You accurately described what the format will be.

Hearings, as our former colleague knows, take on different shapes. In the hearing today, we will hear from people who support the administration's proposal. We will hear from Secretary Brady tomorrow. And then in about 2 weeks, we will be hearing from people from the Chicago community who have a different perspective, to say it mildly, on the administration's proposal.

So it will be spread out over 3 days in order to examine the issue thoroughly.

I want to express my gratitude, of course, to Tom Eagleton for his willingness to be here today and bring some unique and special knowledge from his life after the Senate. We're anxious to hear his comments and thoughts about the issue before us. Let me also thank the other witnesses who are going to be testifying today and throughout these 3 days of hearings.

I want to begin by saying this is a matter that I had hoped would have been resolved, frankly, without having to go through this entire process.

This is the 13th hearing held by the committee and by the securities subcommittee on issues directly related to the October, 1987 market break and the events of October 1989. In some areas, we have made a great deal of progress. The committee voted out the Market Reform Act last November, and we're waiting for the full Senate to take up that important measure.

Mr. Chairman, I've raised the issue with the majority leader. I know you have also. These are issues that I think can be dealt with fairly expeditiously. We're getting near the end of this session and it's now been 7 or 8 months since that legislation has been ready, but I'm hopeful that we can move it soon.

In other areas, we are no further along, unfortunately, than we were 2½ years ago. We are here today, regrettably, because the administration was not able to do at the executive level what virtually every study of the October 1987 market crash said had to be done—that is, to provide a coordinated, consistent, regulatory structure for certain critical issues that cross the boundaries between the stock, options and futures markets.

Senator Proxmire, Senator Riegle and Senator Wirth, myself and others, proposed legislation 2 years ago to mandate coordination by the Federal Reserve, the SEC, and the CFTC on important intermarket issues. But we were told at that time to wait and to hold off because the President's Working Group would resolve those issues.

We now have the unseemly and, in my view, the unacceptable, spectacle of two agencies with enormous responsibility for our capital market fighting publicly over the level and significance of margins, jurisdiction, over new products, clearance and settlement and other important issues.

On these issues, the Working Group has not worked, quite frankly. The heads of the relevant agencies have not pulled together as a team and now Congress has been sent legislation to shift jurisdiction among agencies that should have been able to work together.

Nonetheless, we cannot escape the fact that the issues raised by the legislation are tremendously important for the future of our capital markets, for our long-term competitiveness, and for the capital-formation process in this country.

The legislation raises serious issues and we should give them very serious consideration.

I have particular concerns in the area of margins and I have voiced those concerns in the past. Many of you were here at the subcommittee's March 29 hearing when Chairman Greenspan testified that he was, in his words, "shaken" by the events of October 1989, when future margins were so low that they had to be raised sharply during a period of market turbulence.

I would observe that our options markets have remained the strongest, most competitive options markets in the world under a system of Federal oversight of options margins. No one has yet given me a good reason why our futures markets cannot remain strong and competitive under a system of Federal oversight of futures margins.

The administration's proposal raises a host of other important issues, including the issue of how we can best prevent front-running and other intermarket abuses when regulatory oversight is split between the futures and stock markets.

We have a great deal of work to do, Mr. Chairman, and I hope that our witnesses will share with us their candid, honest appraisals of how we ought to proceed.

I look forward to today's witnesses and the succeeding ones in the coming 2 days.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **Garn**. Mr. Chairman, thank you. I am pleased that you have scheduled these 2 days of hearings on the administration's market reform proposals. We have the opportunity to hear the views of those who oversee and use our Nation's capital markets.

I trust that our distinguished panelists that we have with us today and tomorrow, including our former colleague, Tom Eagleton, and I would say to you, Senator, that while I have not missed some of your votes, I certainly have missed you very much personally. [Laughter.]

We will have Secretary Brady tomorrow, to help us to understand some of the complex issues raised by the administration's proposals. There appear to be some not so obvious ones such as the effect on currency and interest rate swaps.

Apart from the merits of whether we need to shift jurisdiction from one Federal agency to another, what has really disturbed me and why I opposed any action on the floor is how this process has developed.

The administration's bill was submitted to Congress just over a month ago. There was a concerted effort at that time by some members to get a quick floor vote on the administration's proposal as an amendment to S. 1729, the Futures Trading Practices Act of 1989, even though there had not been an opportunity to carefully consider the legislation.

I would note that S. 1729 has been pending for several months. The leadership of the Ag Committee had previously not allowed the bill to be considered by the full Senate because of Senator Gorton's amendment to transfer jurisdiction over stock index futures.

Given this fact, I failed to see the need for ill-considered and hasty action on legislation which could have a very significant effect on our Nation's capital markets.

Now that the administration's proposal has had a chance to circulate, a number of questions have been raised which I expect will be addressed by today's witnesses. However, something that would not be helpful would be to engage in some of the hyperbole that I heard from both sides of the fence on this issue.

Those that oppose the administration's proposal argue that no changes to the status quo are necessary, that cooperation will cure any market ills.

I certainly wish that that was the case. Unfortunately, I know better.

A year and a half ago, I sent letters to both Chairman Gramm and then Chairman Ruder urging them to cooperate to resolve the impasse over index participations. As we all know, however, cooperation did not work and the issue ended up being decided by the courts.

On the other hand, proponents of the administration bill suggest that enactment of the legislation will go a long way toward moderating market crashes. I think that's an overly simplistic view and I'm not convinced that that case has been made.

We cannot and should not try to legislate away market declines, nor should we unduly interfere in the normal operation of the markets.

Competitive efficiency and safe markets should be our goal. Our job should be to provide a regulatory structure which allows those goals to be met most effectively.

This committee has already passed the Market Reform Act and the Securities Law Enforcement Remedies Act, which should help achieve such a result. The Future Trading Practices Act passed by the Ag Committee also appears to be a step in the right direction.

So today and tomorrow, I hope we'll have a better understanding of whether the administration's proposal is necessary.

Thank you, Mr. Chairman.

Senator Dodd. Thank you, Senator Garn.

Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator Dixon. Mr. Chairman, this is the committee's first day of hearings on S. 2814, the administration bill known as the Capital Markets Competition, Stability, and Fairness Act of 1990.

And I point out the bill's number because in looking at the testimony of this morning's witnesses, none of them seem to know it. I thought at the outset that I should provide this public service to all of our witnesses and note for them one other fact, that this bill, S. 2814, has been referred to the Senate Agriculture Committee and is now pending before that body.

I do not want to suggest that this committee ought not to be holding hearings on this measure. I do believe, however, that it is worth pointing out that this bill, like every bill, is being handled under the rules and the precedents of the Senate.

That is as it should be. That and only that is what the administration is entitled to.

I don't want to take a lot of time before we start. I know we have a lot of witnesses before us today. However, Mr. Chairman, I do believe it's worth quoting from three items before we begin.

First, I want to read a letter signed by 24 agricultural groups opposing this administration bill. This letter was sent to me yesterday and every Senator has received an identical letter.

Dated July 10, mine says:

> Dear Senator Dixon: We the undersigned, representing a broad spectrum of American agriculture, urge the Senate to promptly pass S. 1729, a bill reauthorizing the Commodity Futures Trading Commission. We also reiterate our strong opposition to any proposals that would weaken the CFTC.
>
> Specifically, we urge you to oppose an administration amendment which would, among other things, transfer jurisdiction over stock index futures from the CFTC to the SEC.
>
> We believe the amendment would, one, weaken the CFTC at a time the agency should be strengthened; two, create regulatory chaos for futures exchanges and industry professionals who would be regulated by two different agencies with different and often conflicting sets of rules; three, endanger commercial market liquidity by requiring Federal regulators to set margins; and four, demonstrate a profound lack of knowledge of the sensitive nature and operation of futures markets.
>
> Treasury Secretary Nicholas Brady met with agricultural groups on June 28 and asked us to step aside on the Treasury SEC proposal. Mr. Brady, ironically, argued that agriculture would benefit by the proposal because it would allow the CFTC to focus its efforts on agricultural markets.
>
> We reject that argument. We write once again to make our position crystal clear.
>
> The Treasury SEC amendment is bad for agriculture and, accordingly, it's bad for America. Agriculture supports a strong, independent CTFC as a policeman of the Nation's futures markets, a CFTC with more, not less, resources to oversee all futures markets.
>
> S. 1729 would accomplish that goal.
>
> The Treasury SEC proposal would directly affect agricultural interests, forcing futures exchanges firms and other market professionals to follow two different sets of rules. The proposal would dramatically increase our cost of doing business.
>
> Those who benefit most from America's futures markets, consumers, will ultimately bear those costs. The jurisdiction issue is not a battle between Wall Street and LaSalle Street; it is an attack by Wall Street on Main Street.
>
> Therefore, we urge you to consider our concerns and to support a strong independent CFTC as the exclusive regulator of the Nation's futures markets.

It is signed, Mr. Chairman, by the American Farm Bureau, the National Farmers Union, and 22 other farm organizations representing every commodity interest in the country.

Second, I'd like to quote the distinguished Secretary of the Treasury, Nick Brady.

As everyone here knows, before the distinguished Secretary became the distinguished Secretary, he was head of the Presidential task force charged with investigating the 1987 stock market crash.

According to the Wall Street Journal, in early 1988, at least, Secretary Brady felt that "the Securities and Exchange Commission shouldn't be made the overarching regulator of the financial markets."

Testifying before the House Subcommittee on Telecommunications and Finance, then-investment banker Nicholas Brady stepped up his opposition to the SEC's bid for expanded powers.

Before the Senate Agricultural Committee last week, Mr. Brady dismissed as politically unrealistic the agency's bid to take over regulation of stock-related futures products.

In testimony yesterday, Mr. Brady and the executive director of his task force not only rejected the idea of a broad reorganization of regulatory jurisdictions, but also argued that the SEC isn't even capable of taking on the job of overseeing cross-market issues such as margins, circuit breakers to coordinate closing of overheated markets and clearing and settlement of trades.

Frankly, Mr. Chairman, I couldn't have said it better myself.

Finally, I'd like to quote from the report to the New York Stock Exchange on market volatility and investor confidence, chaired by the chairman of General Motors, Roger Smith.

And according to that report:

> Some market participants believe that index arbitrage increases stock price volability. Empirical evidence suggests that index arbitrage is most likely only the messenger through which new information gets incorporated into stock prices, but it is not the primary causes of price changes.
>
> There's little evidence that index arbitrage causes an increase in volatility as usually measured.

May I close, Mr. Chairman, by saying two things.

One, there are two bills on the floor of the Senate that have languished for a long time. S. 648 reforms and adds power to the SEC. S. 1729 reauthorizes the CFTC, strengthens it, reforms it, and gives it additional powers and raises additional money for the CFTC to effectively function.

And I would say to the Chair, to every member of this committee and to the public at large, these two bills are desperately needed, should not be held up, and ought to be passed.

And I close by saying this. We are witnessing a great many smart people doing a very dumb thing, involved in a vicious turf battle that will leave the field strewn with torn, bloody bodies, all the while the administration surreptitiously goes through the hallways advocating a transfer tax that will drive all the markets to its knees and steal this business from us and send it to London and Japan and Hong Kong and other places.

It is the classic mistake of smart people doing an exceedingly dumb thing.

And I thank the Chair.

Senator Dodd. Once again, our colleague from Illinois has quietly expressed his views. [Laughter.]

I would just point out to my good friend and colleague from Illinois that is something goes awry here in the markets, I suspect that the media will not be calling Senator Leahy when there's a market problem. Normally, the Banking Committee is the committee that will get the call.

Why the legislation ended up in the Ag committee is, I think, rather obvious. But nonetheless, this committee will probably be answerable if things go astray more so than any other committee, as we have already seen.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Well, Mr. Chairman, I wanted to welcome Tom Eagleton, but at the rate things are going, I won't be able to welcome him this morning.

But it's still good to see you, Tom. We're delighted you're here. We look forward to your testimony.

By the way, in case you're wondering why you're here, since Senator Dixon alluded to the fact that the legislation before us, S. 2814, hasn't been referred to the Banking Committee, I would inform you that, as you will recollect and remember, that irrespective of the substance of legislation, and the substance of S. 2814 indeed does deal with securities market regulations, the practice in the Senate, where we have no custom on either joint or sequential referral, is that any committee which would be forced to cede jurisdiction by the enactment of legislation becomes the committee of referral.

Hence, since the Agriculture Committee would lose certain elements of jurisdiction were the administration bill to pass, it, quite properly under Senate precedent, goes to the Agriculture Committee.

All of which goes to show that we should never have given them everything we gave them back in the early 1980's, and we'll be more careful next time.

Mr. Chairman, as everybody is aware, there are really three principal components to this legislation.

One provides Federal oversight of margins on stock index futures.

Another modifies the exclusivity clause.

A third designates one agency as the responsible one for coordinating the regulation of stock, stock option, and stock index futures.

I'd like to make clear that I don't think at any point has the administration, or any of the sponsors of the bill, indicated that the SEC should be the overarching regulator, as I think Senator Dixon indicated, of the financial markets.

That's why the legislation proposes only that the SEC be given responsibility for derivation products that directly impact the capital formation process and that are derivative of equity securities.

I'd also observe that this is an issue where it would have been nice had the so-called Working Group worked it out. That Working Group consists of the Secretary of the Treasury, the Chairman of the SEC, the Chairman of the Fed, and CFTC Chairman Wendy Gramm.

There was a consensus. Three of the four members of that Working Group felt that these were, on balance, fairly reasonable recommendations. Wendy Gramm at the CFTC did not.

And because the Working Group couldn't work things out, we are here in the Congress trying to do it ourselves.

It is contentious, but I believe that it is our responsibility as Members of Congress to make sure that our markets, particularly ones involving stocks, options, and futures alike, are stronger and safer and more competitive.

There are going to be those who use this legislation to divide market against market, regulator against regulator, even committee against committee. But that's a smokescreen. That's a smokescreen for the real issue here is the integrity of our financial markets.

I recollect on the savings and loan legislation that came before here that the same game was played by those who didn't want 4 years ago—Senator Garn can tell you this chapter and verse, in particular, because he was chairman of this committee over part of that that time period—to divide the Congress between people who were against housing and for housing.

And that was a smokescreen. It was a question of whether we were going to reform and regulate the S&L's on a timely basis. And we did not.

I, for one, don't want the Congress to be put behind any kind of a screen because when that screen falls down, we often find a very ugly picture afterward.

So I think it is critical that we find a regulatory scheme that's rational, that is effective, and that we can all agree on. And of course, that's why we've invited you here today, to give us your insights, Tom, and our other witnesses as well.

So, Mr. Chairman, I ask unanimous consent that my entire statement be a part of the record.

Senator Dodd. Without objection, so ordered.

[The complete prepared statement of Senator Heinz follows:]

Statement of the Honorable John Heinz
Committee on Banking, Housing and Urban Affairs
July 11, 1990

Mr. Chairman, I join in welcoming our former colleague Tom Eagleton and our other distinguished witnesses and commend you for holding these hearings on the Administration's proposed legislation to strengthen the intermarket regulation of our capital markets. The Senate will consider, debate and vote on "The Capital Markets Competition, Stability and Fairness Act" submitted by the President. These hearings will help build a record to assist our colleagues in their deliberations on this legislation.

Last March the Securities Subcommittee invited the members of the Working Group on Financial Markets to express their views on the three measures contained in the Administration's proposed legislation. These measures are designed to:

- strengthen the integrity of the nation's financial system by providing federal oversight of margins on stock index futures;
- promote innovation of financial products by modifying the so-called "exclusivity" clause of the Commodity and Exchange Act; and
- protect the stability of our capital markets by giving one agency responsibility for coordinating the regulation of stock, stock option and stock index futures markets.

Undersecretary of the Treasury Robert Glauber, SEC Chairman Richard Breeden, and Federal Reserve Board Chairman Alan Greenspan supported each of these measures. CFTC Chairman Wendy Gramm did not. Since the Working Group has no mechanism to resolve this dispute, it is up to Congress decide how best to make our markets -- stocks, options and futures alike -- stronger, safer, and more competitive.

There may be those who have will seek to use this legislation to divide market against market, regulator against regulator, and even committee against committee. But Congress is not being asked to choose sides. We have strong securities markets and strong futures markets. But we don't have effective intermarket regulatory coordination. That is the problem that this legislation is designed to address.

I am confident that we can all agree that our markets must work in harmony. These issues deal with national markets, with participants in every part of the country, which serve the capital needs of companies in every corner of the United States. When it comes to addressing issues that affect our financial markets - - a vital national asset - - we all must stand on common ground.

Senator DODD. Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman.

First of all, I want to commend you for holding these hearings. I want to commend you for holding these hearings. I think they're extremely important and I think the issue of the stability and integrity of our Nation's financial markets is a matter of the greatest import.

I note that the Presidential task Force on Market Mechanisms, after the stock market crash in October 1987, amongst other things, concluded that regulatory changes were necessary to reduce the possibility of destructive market breaks and to deal effectively with such episodes should they occur.

It's all fine and dandy to talk about turf battles and other similar matters, but if you get another market break with the consequences that that would entail, and have this inadequate regulatory structure as a causal factor in bringing that about, we'll be held to account for it. And therefore, I think these hearings are very important. I think a reasoned judgment on what ought to be done is extrremely important.

In that regard, I am delighted that Senator Eagleton is here with us this morning, and is, in fact, the lead-off witnesses.

I'd like to sort of pickup on what Senator Garn said and say to Senator Eagleton that I have both missed you personally and missed your vote. [Laughter.]

Senator DODD. No one's missed your speeches yet. [Laughter.]

Senator SARBANES. I'm prepared to throw the speeches in as well. [Laughter.]

Let me simply say, during our years of service together and before, in watching him closely, I came to know Tom Eagleton as a person of keen intelligence and the highest integrity.

He's had direct, first-hand experience in the operations subsequent to his service here in the Senate in the operations and regulation of the futures markets. I'm delighted he's come here this morning to share his experience with the committee.

I, for one, believe that I will profit and learn a great deal from what he has to tell us, and I want to commend the Chair for having him as our lead-off witness and to thank him for his continuing public service.

Thank you.

Senator DODD. Thank you, Senator Sarbanes.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I join you and our colleagues in welcoming Senator Eagleton and I'm interested in hearing what he has to say, and I look forward to that.

Senator PRESSLER. I join in welcoming you here, Tom. I look forward to hearing your testimony.

Senator DODD. Senator Bond? I'm sorry. I didn't see you.

Senator Bryan.

Senator BRYAN. Well, I would, too, join in the accolades, Mr. Chairman, to our lead-off witness. But I'm eager to hear from him, so I'll keep my comments abbreviated.

Senator, nice to have you with us.

Senator DODD. Senator Bond.

Senator BOND. Mr. Chairman, I think we're getting to be on a roll now. We might get to hear our good friend Tom before noon. [Laughter.]

I will save my comments until later, other than to say that while I join in the warm comments about our dear friend, I was somewhat disheartened by the statement of our distinguished ranking member, backed up by my good friend and colleague from Maryland, who keep saying they want you back so much. [Laughter.]

There's not really room for three of us from Missouri. I will carry on discussions later on with brothers Sarbanes and Garn. [Laughter.]

Jake, at least I had hoped better from you. [Laughter.] I expected that Paul might feel that way. [Laughter.]

I also want to say for the record now, prior to our embarking on the third panel, we have another outstanding Missourian, John Bachman, whom I became acquainted with the same way I became acquainted with Tom Eagleton, on the dusty and hot campaign trails of Missouri.

He, too, has now found an honorable profession, He has moved on to a distinguished spot as head of a very significant regional brokerage firm. And I know that the committee will gain a great deal by hearing his testimony.

I look forward to hearing the testimony of all the witnesses.

Thank you, Mr. Chairman.

Senator DODD. Thank you very much, Kit. A lot of pressure on you, Senator Mack.

Senator MACK. No comment. [Laughter.]

Senator DODD. Before we begin I have statements from Senators Sasser and Shelby.

PREPARED STATEMENT OF SENATOR SASSER

Thank you, Mr. Chairman, for scheduling this hearing on the capital markets legislation that's being advanced by Secretary Brady. I have been concerned about this issue for some time. Volatility in the securities markets and the flight of the small investor are problems we all want to address.

Today, many fewer individuals own stock, than did 20 years ago. Indeed, the proportion of corporate equity owned by institutions has doubled. Large institutions now control our markets.

This is unfortunate. With fewer individuals in the market, we have fewer long-term owners. Investing in stock used to be for a lifetime; investors were interested in the long-term viability of companies. Today, a long-term investment for an institutional investor could probably be accomplished in the amount of time it takes me to make this statement.

Enormous blocks of stock of our major corporations are changing hands hourly. It is very difficult for our corporations to take the long-term view that is so necessary for us to compete in the world economy.

Mr. Chairman, program trading and index arbitrage—trading futures in one market and stocks in another—are common practices of institutional investors. And these practices have been linked by most authorities to the volatility in todays markets.

There are any number of causes of this volatility. It may be that trading in stock futures is the leading cause. However, it may be simpler than that. It may be that we have volatility simply because much more stock is owned by institutions. And these institutions tend to turn over their ownership faster.

Senator Sanford and I have introduced a bill that extends an antichurning rule that already applies to the mutual funds to other institutional investors. think that this is an approach that has promise; indeed, Secretary Brady has so indicated.

So I look forward to hearing today's testimony on the administration's proposal to transfer jurisdiction over stock index futures to the SEC. This is a complicated proposal and it deserves special scrutiny. Thank you Mr. Chairman.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Mr. Chairman, I am glad that you have scheduled this hearing. I appreciate your giving this committee an opportunity to get to the bottom of this debate.

Mr. Chairman, I hope that today's hearing will ferret out the truth. The administration, and my colleagues that have volunteered to offer the administration's proposal as an amendment to the Futures Trading Practices Act of 1989, have labeled their efforts as a cure for the volatility in the markets. I agree with my colleagues that volatility in the capital markets is a problem. It is true that small investors have become leary of the market, unwilling to participate because of large movements in the Dow Jones Industrial Average on a daily basis.

But Mr. Chairman, while I believe that my colleagues have correctly identified the problem, I do not believe that their proposal is a rational response. In fact, I believe that it is quite the opposite in that, as a result of all the publicity this effort has received, it will merely delude small investors into thinking that market stability has been restored.

The Ad Hoc Coalition for Intermarket Coordination—which is a consortium of rival exchanges—has hired one of DC.'s preeminent law firms to represent their case and this firm has put together a very nice little briefing book. The first section purports to tell what the Capital Markets Competition, Stability, and Fairness Act does and why. This briefing book repeats the familiar argument—permitting the SEC and not the CFTC to regulate stock index futures is going to, and I quote, "restore investor confidence in the markets." "Putting one traffic cop in charge of one market, . . . (would) signal to investors that the confusion that plagued the markets in October 1987 and 1989 will not occur again." Artfully phrased—it does not say that the confusion will not occur again but rather says that this "would signal to investors that the confusion will not occur again."

Mr. Chairman, I wonder if the ad hoc coalition would like to make this guarantee to investors in writing? In looking over communications from the administration, it seems that they stop just short of making this claim but the message is the same. These few simple changes in regulation are being touted as the cure for the evil volatility in the marketplace.

Mr. Chairman, the SEC has, on average, proved to be a good regulator. Different chairmen have demonstrated different styles of leadership but I feel very strongly that the current leadership at the SEC is competent and energetic and I have no doubt that under Mr. Breeden, the Commission will vigorously perform its responsibilities. But the SEC already has a huge work load. Every time this committee discusses the SEC reauthorization we discuss how its oversight and regulatory responsibilities have grown exponentially, while its staff and resources have increased only marginally. And now we want to put another very active, very complex product under its jurisdiction?

I am afraid that the administration has done a very good job of raising expectations that cannot be met. If I were the administration, I would not want this bill to pass because I don't think this jurisdictional change will follow through on the results that have been promised. I am getting calls and letters from constituents that want me to support this chance because they believe it will end the volatility in the market. If I believed that it mattered which Federal agency was calling the shots, I would gladly support this change. But Mr. Chairman, it won't. The CFTC is very ably led, and has proved very competent in regulating stock index futures. The CFTC is experienced in this area—the SEC is not.

We could make this change, and the brokers could represent to investors that the markets have now been made safe for the investing of grandmother's retirement money or junior's college fund. Is the Federal Government going to pay when the persistent problem of volatility dashes the value of their investment in one afternoon? To what evil will the administration point at that time?

My understanding of the basis for the volatility in the market leads me to attribute the volatility to fundamental changes in the size of the market participants and the trading strategies that these participants utilize. While I am not proposing that I know how we can effectively limit program trading without diminishing liquidity in the market or driving trading offshore, I do believe that computer driven trading strategies used by large institutional investors are primarily to blame for the volatility in the market. Yet, in large part, these institutional investors represent the interests of grandmother and junior, in the form of pension funds, mutual funds, and endowment funds.

This is a period of fundamental change in the capital markets. Short term gains have become preferable to long term investment in both the public and the private sector and it is this fundamental difference that makes the capital markets a different place in 1990 than in 1940 or 1950 or 1960. Just as the Federal Government must get its fiscal house in order, corporate America in conjunction with institutional investors must reset its sights on the long term rather than the short."

Mr. Chairman, I commend my colleagues and the administration for identifying the problem, that of extreme volatility in the markets. But I would urge my colleagues to search for a real cure rather than a panacea.

Once again, Mr. Chairman, I am pleased that you have called this hearing and hope that my colleagues can use this forum to settle the issue.

Thank you, Mr. Chairman.

Senator Dodd. Tom, we welcome you.

STATEMENT OF THOMAS F. EAGLETON, THOMPSON & MITCHELL, ST. LOUIS, MO

Mr. Eagleton. Thank you, Mr. Chairman. I'm honored to be here today—to attend my own funeral. [Laughter.]

I enjoyed everything that was said.

As a prelude, let me say that I did serve for almost 3 years upon leaving the Senate as a member of the board of governors of the

Chicago Mercantile Exchange. And I resigned from that exchange in November of last year, in somewhat strenuous disagreement with their procedures and practices and customs.

It's in that capacity, based on that experience, 3 years on the Merc board, that I'm here today.

I recognize what Senator Dixon says—this is a turf fight. It is not a petty, picayune turf fight.

This is a turf fight about trying as best Government can do with foresight to avoid another crash of 1987, or another crashette of 1989.

I was around during the crash of 1987, on the board of governors of the Chicago Mercantile Exchange and saw the consternation and the dismay with the continuing calling New York and New York calling Chicago, what are we going to do? Well, can we do this in common? No, we do it this way out here. No, we do it this way up here. Our procedures and practices are this way. No, ours are this way.

It isn't pork bellies that will bring down the financial structure of the United States of America. But anohter 508 or a 1,008 of stocks and stock futures could bring down the financial structure of the United States.

THE CFTC IS NOT DOING THE JOB

It is lunacy to say that two different traffic cops ought to be policing this on a given day of crisis. It is lunacy to depend on the CFTC traffic cop that is perpetually asleep on the watch. It's the sleepiest agency in the history of America.

The only thing sleepier is the Federal Election Commission that I know of. [Laughter.]

The CFTC is befuddled, confused, understaffed, undermanned, underfinanced. They're in a perpetual state of disarray, and have been since it was created back in 1974.

I know a little about that. I was chairman, believe it or not, of the Agriculture and Appropriations Subcommittee and had jurisdiction over funding of the CFTC back in its beginning days.

It is no agency to which to trust the financial future of this Nation. Stock index futures are just too big a deal for this country and for the marketplace to be trusted to the CFTC.

Now, that's not to say that the SEC has since the early 1930's when it was created under President Roosevelt, had an immaculate record of perfect enforcement and doing everything right. This morning's newspaper proves that not to be the case, when the jury came in on the man against whom Mr. Boesky gave his very sordid testimony.

So the SEC isn't perfect.

But what this Congress has got to be thinking about is devising a method of regulation to deep these matters out of the criminal court.

If a regulator is doing his or her job, then there is no need for sting operations in Chicago. There is no need for 48 indictments in Chicago. There is no need for indictments elsewhere in the country, if the regulators are doing their job.

Two policemen, I respectfully submit, cannot do the job in times of crisis that existed in the fall of 1987, 508 on the Dow and the fall of 1989, what was it? 180 or 190 points.

And so that's why Mr. Brady, who knows more about this subject matter than any other living American, says this bit of jurisdiction that's in the CTFC on stock index futures, this bit of jurisdiction should, in the interest of uniform enforcement and uniform practices, be given in terms of enforcement to the SEC.

This will not close down that trading in Chicago. Nobody's going to lose a dime out there. Nobody selling S&P 500's is going to lose a penny in Chicago.

What they will lose, and what they would not want to lose, is the benefit of lax enforcement.

People in Chicago love the CFTC. And the CFTC is the only agency I know that shudders at the sight of those it regulates. Usually, the regulator comes into town for example, the FCC, and all the radio stations and all the TV stations get nervous. The CFTC is the pygmy regulator in terms of lack of guts, lack of foresight. It is the CFTC that tremble~~s in the ve~~ry sight of Chicago.

And that's why Chicago wants stock under futures left in the CFTC. And that's why it does not want this jurisdiction transferred to the SEC.

I ask unanimous consent, if I haven't previously done it, that my statement in full be printed in the record as though read.

Senator Dodd. Without objection, it will.

[The complete prepared statement of Thomas Eagleton follows:]

STATEMENT
OF
THOMAS F. EAGLETON

BEFORE THE
UNITED STATES SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

July 11, 1990

Mr. Chairman, I appreciate your invitation to testify before the Banking Committee this morning on the "Capital Markets Competition, Stability and Fairness Act of 1990." This legislation represents an important and necessary reform of our current system of regulating both the equity and futures markets.

For almost three years (1987-1989) I served as a member of the Board of Governors of the Chicago Mercantile Exchange. I resigned from the Merc Board in November of last year. I came to the considered belief that the Merc was being operated _by_ insiders _for_ the benefit of insiders, and that Joe Average Guy was not getting a fair shake. The "final straw" in terms of triggering my resignation was the way the Merc and certain of its principals handled --- I should say "mishandled" --- the CFTC fraud investigation involving Brian Monieson, a former director and chairman of the Merc, and his firm, GNP Commodities, Inc. In May of this year, Mr. Monieson, GNP Commodities, and two of the firm's brokers were fined and permanently barred from the futures industry.

While the Monieson matter was the immediate and proximate cause of my resignation from the Merc's Board, the Merc's handling of the affair was merely symptomatic of much broader ailments affecting the regulation of our country's futures exchanges.

Stated quite simply, the current system of "self regulation" -- which the Chicago exchanges tout as the be-all and end-all in assuring the integrity of the futures exchanges -- does not work. I state this flat out. The futures industry deals in billions and billions of dollars and millions and millions of transactions each year. In terms of its fiduciary relationship to the public, the futures industry is akin to a bank or a savings and loan institution. No one in this day and age would espouse that the banking or S&L industry be collectively self-regulated.

Compounding the failure of "self-regulation" is the benign and timid supervision of the futures exchanges by the CFTC. The CFTC is about as sluggish a regulatory agency as one can find. It's about as zesty as the Federal Election Commission. Alone among federal oversight agencies, it has to be reauthorized every three years. Thus, the CFTC members live in mortal fear of the exchanges they regulate -- fear that the exchanges will ask Congress to either terminate the Commission at its next reauthorization date or somehow further restrict its limited authority or its paltry budget.

Perhaps 90 to 95 percent of the Commission's professional staff time is tied up with processing routine, albeit necessary, work. Only the remaining time -- and as few as 25 to 35 people -- are available to respond to major policy and investigatory matters affecting the futures industry. The Chicago sting operation in the futures pits by the Federal Bureau of Investigation produced 46 indictments against traders in 1989. After the sting, the CFTC, this pygmy of federal regulation, overwhelmed by its day-to-day operations, came plodding along with too-little, too-late to catch fast-moving crooks and fast-changing events.

As I testified before the Senate Agriculture Committee last October, in my view, S. 1729, the CFTC reauthorization bill reported by the Agriculture Committee last fall, goes a long way toward correcting several of the more serious ills affecting the futures industry. For example, the provision of S. 1729 requiring development of a verifiable, electronic audit trail is a critical first step toward curbing the abusive self-dealing that the "open outcry" system has facilitated. As long as the existing system of open outcry remains, there will be substantial cheating at the futures exchanges. The exchanges have to be brought into the 21st century with an electronic trading system that leaves a verifiable audit trail.

While the excellent work of Senator Leahy, Senator Lugar and the Agriculture Committee has produced the beginning of a package of important and necessary futures reforms, we must go farther in reforming regulation of the Nation's financial markets.* I am convinced that the Administration's proposal to shift jurisdiction over stock-index futures to the Securities and Exchange Commission will have a positive effect, not only on the markets for equities and equity-derivatives, but on the nation's commodity futures markets as well.

A point that has been overlooked in much of the recent debate concerning the Administration's proposal is that the transfer of jurisdiction over stock-index futures to the SEC will free a good deal of the CFTC's staff and resources to focus on the Commission's unique and historic mission -- to ensure fair and stable futures markets for the Nation's physical commodities, both agricultural and otherwise. The Commission's regulation of stock-index futures -- commencing in 1982 -- has diverted the agency from the original purposes Congress had in mind when the CFTC was created.

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*My major objection to the Leahy-Lugar package is its failure to ordain a phase out of "open outcry" in favor of a modern, verifiable electronic system.

I was a member of the Senate when the CFTC Act was enacted in 1974. Congress acted out of an overriding concern that the country's farmers, producers and consumers must be provided with a futures market that was fair, evenhanded and efficient. As the Senate Agriculture Committee stated in its report on the CFTC Act:

> In recent years, the consumer has become increasingly aware that futures markets have a direct effect on such matters as his grocery bill and the cost of his home . . . In order to assure that futures markets operate properly and that the prices consumers pay are not artificially high, careful and efficient supervision of the markets is essential . . . . If individual speculators or groups operating in concert obtain control of the futures markets, price manipulation, corners and squeezes can occur, with adverse effects on producers and consumers alike.

The world of stock-index and other financial futures was neither contemplated nor foreseeable at that time. The CFTC was created to ensure the integrity and stability of the commodity futures markets -- a purpose no less important today than it was in 1974.

Beginning in 1982, however, the attention of the CFTC and its staff has increasingly and understandably been turned away from the critical job of regulating futures on agricultural products and other physical commodities. Instead, the CFTC has focused its increasing time and its meager resources on the more exotic world of stock-index futures and other financial products. I believe that the interests of America's farmers, producers and consumers, as well as its investors, have suffered as a result.

I do not have to remind my friend, Senator Bond, or other farm state senators of the turmoil created a year ago in the futures markets by the Ferruzzi fiasco -- when the Chicago Board of Trade issued an order forcing traders into a huge sell-off of soybean futures contracts. That order cost American farmers millions of dollars as soybean prices entered a free-fall.

There can be little doubt that episodes like the July, 1989 soybean order and the FBI sting on Chicago's trading pits have shaken the confidence of America's farmers, ranchers and consumers in the integrity of the futures markets and in the effectiveness of the CFTC. By shifting the regulatory jurisdiction over stockindex futures to the SEC, Congress will be at least partially restoring the CFTC to its statutory mandate: the regulation of commodity futures trading. With its efforts and resources focused more sharply on this important mandate, the CFTC will be better able to serve the interests of America's farmers and ranchers whose livelihoods are affected by each twist and turn of the commodity futures markets.

The Administration's proposal will also provide needed reassurance to individual investors in our equity markets. The market breaks of Octiber 1987 and 1989 have shaken investor confidence and jeopardized capital formation in America's markets. Investors understand that the stock-index futures markets exert a strong and often volatile influence on the markets for their underlying securities. Indeed, we are all too often reminded of the inextricable connection between these markets.

Just a couple of weeks ago, on Friday, June 22, for no obvious reason, the Dow Jones Industrial Average plunged more than 60 points in less than 1-1/2 hours of trading. According to an article in The Washington Post, "[c]ash markets and futures analysts were stunned by the late, program trading whipsaw -- perhaps the most volatile futures related trading since . . . the October 13, 1989, 'Friday the 13th' massacre . . . ."

The Administration's proposal to consolidate authority over stock and stock-index futures under the SEC will permit a more rapid, coordinated and flexible regulatory response to such market disruptions. A single federal regulator of equity and equity-derivative products will be better able to address critical intermarket trends and problems -- hopefully avoiding or at least minimizing the destructive impact of market disruptions on individual investors and other market participants. The Administration's proposal offers sound and workable reforms that will provide a unified regulatory framework to address stock market volatility and help restore investor confidence in the Nation's capital markets. We cannot afford to sit idly by and wait for the next big market crash.

Finally, and quite bluntly, as long as stock-index futures remain under the jurisdiction of the CFTC and thereby overwhelm the CFTC's efforts, there will be an aroma of distrust in the minds of the trading public as to the scope and vigor of market surveillance. There's an old and respected stockbroker in St. Louis who puts it this way, "Those Chicago boys are too slick for the sleepy CTFC."

Mr. Chairman, the CFTC is underfunded, underenthused, and overwhelmed. It may be a good thing for professional baseball to be split into two leagues. It makes no sense for equity or equity derivatives to be split into two varying regulatory playing fields.

Senator DODD. Let me ask you a couple of questions, Tom. We're reminded why we miss you. You don't take 20 minutes to express your views or thoughts on a matter like this.

MOST CREATIVE MARKETS ARE IN CHICAGO

People in Chicago and elsewhere have made the point that the most creative market in the country has been Chicago, that they have been the ones who have been innovative. They're the ones who are coming up with new products. They're the ones who are really making a difference in the international competition area.

They say that as a result of that ability to be creative, to be innovative, they've been able to hold on to a larger share of the market internationally than New York has. In fact, we're watching the European markets, the Japanese markets clobber the New York markets in many ways.

And what they say is, fine, you guys want to come in, you want to take an agency that's basically stifled activity in New York and you now want to apply it to one area of market activity that has been able to do a very effective job in keeping business on this side of the Atlantic or this side of the Pacific.

How do you respond to that?

Mr. EAGLETON. Yes. The subsequent witnesses will put in the record, I'm sure, a list of the new items that the SEC has approved and are being marketed on the New York Stock Exchange and other exchanges under the SEC's jurisdiction.

By title and number, it's perhaps a longer list than has come out of Chicago.

But I don't gainsay that Chicago lacks creativity in thinking up of new instruments. About 5 percent of the jurisdiction of the CFTC would be transferred to the SEC under this proposal. This modest transfer of a tiny portion of the CFTC's jurisdiction in no way will stifle the creativity of Chicago.

They are very intentive people. I concede that.

They have invented a thing, for instance, called Globex. You were talking about international trading. I was there when Globex was being created. The peculiar thing about Globex is that you'll be able to trade electronically all over the world. Except one place. Guess where you will not be able to trade electronically?

You'll be able to trade electronically in Hong Kong, Singapore, Tokyo, Bahrain, I guess. The only place you will not be able to trade electronically—Chicago. Why? Because Chicago wants to keep the open out-cry system, the winks and the nods and the blinks.

That's the biggest loophole through which you can drive a Mack truck, if they still make Mack trucks.

The Merc invented Globex, but they don't want to invent it for themselves in Chicago. But this will not stifle one whit, one scintilla, the ability to create new instruments as the market needs them, as the market demands.

Senator SARBANES. Mr. Chairman, could the record show that they do still make Mack trucks in Hagerstown, MD. [Laughter.]

Senator DODD. Chairman Riegle wanted to know if it was Bahrain where they were made. [Laughter.]

Senator SARBANES. No, Hagerstown, MD.

Senator DODD. The record will so reflect that, then.

Tom, some have suggested that rather than get into this battle of giving the SEC jurisdiction, why not, on the margin issue, give it to the Fed? This might solve some of the turf concerns that people have, the battle between the various committees. It might be argued that, as long as someone's setting those margins, rather than being done in-house, that you solve the problem.

How would you respond?

Mr. EAGLETON. That goes from two cops to three cops, sort of. Up until this day, it would be SEC doing their thing, the CFTC doing their thing, then we got the Fed doing sort of their thing as well.

It seems to me that might be the worst of all worlds, to further diffuse jurisdiction more broadly.

I take it from the bill that more than margin is involved.

Senator DODD. Yes. The exclusivity rule is also part of that.

Mr. EAGLETON. Yes.

Senator DODD. The one that seems to be causing the most controversy, I think, is the question of margin. That's the one that really seems to be the focus.

Mr. EAGLETON. Well, I think also a question of enforcement is involved as well, isn't it, Mr. Chairman?

Senator DODD. Yes. Correct.

Mr. EAGLETON. Enforcement is a mighty concern to the CFTC and for Chicago—the least, the better. The least, the better. Chicago believes in this thing called "self-regulation." Self regulation. That's like a country club and one of the members has a few too many drinks and they say, well, don't call on the alcohol and tobacco unit and yank him away. Tell him to go home and sober up.

That's self-regulation. That's the way they think Chicago ought to be run—a little self-regulation. Leave the driving to us. And that's what the CFTC does. They leave the driving to Chicago.

Senator DODD. Well, that's a good point. But the response, I suppose, would be, well, all the problems occurred in New York. Everything ran well in Chicago. In both 1987 and 1989, they did not have the situation that occurred in New York.

If the wheel ain't broke, why fix it? Things seem to be running pretty well. They're being innovative. They're being creative. The problems weren't created there. They didn't exist there. Things move smoothly all during that period of time.

Why the devil are you running around trying to solve a problem that doesn't exist?

Mr. EAGLETON. Well, you know, Woodrow Wilson proposed something akin to the SEC and people said that we really didn't need it. We didn't really need it until October 1929. And too bad we didn't have it. And then we spent 3 or 4 years trying to create it.

So what you're trying to do is, I think, Mr. Chairman, is you're trying to prepare the Government as best you can for another 508 down on the Dow, God forbid, and say, what powers should be allocated to what agencies to do what in order to avoid or to better cushion a 508.

As I said, pork bellies aren't going to explode the financial world. But stocks, stock index futures, could. And did on the 508 day in October 1987.

Senator **Dodd**. Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman.

Tom, from your testimony, I can assume, although you didn't explicitly say it, that you support the Brady bill.

Mr. **Eagleton**. Yes, I do. With some degree of vigor.

Senator **Garn**. I listened very carefully and concluded that.

Obviously, we've got very distinct differences of opinion. On the other side, Senator Dixon feels very, very strongly in the opposite view, and beyond the issue of turf battles. We're hearing from a lot of agricultural groups. They're not CFTC. They're not the exchange. But farm groups who say that it's adversely going to affect them and farmers.

You're from a farm State. You've been a Senator. You've been on the board of the Chicago Mercantile Exchange (CME).

How do you answer that argument of the farm groups that it's going to hurt them?

OPPOSITION OF AGRICULTURAL GROUPS

Mr. **Eagleton**. That's just a figment of someone's imagination.

The CFTC, when it was created back in 1974, was solely an agricultural operation dealing with all kinds of agricultural commodities that it was created to supervise. Then in the early 1980's, it got into some of these financial instruments and currencies and what have you. It grew into that, but it started as a purely agricultural entity.

I don't know how taking this tiny bit of jurisidiction from the CFTC and putting it over into the SEC has anything to do with what you're going to do about wheat or corn or eggs or butter.

In fact, the argument can be made—I don't think it's an overwhelming argument—that freeing up of this, the sexiest part of this operation that takes a disproportionate amount of the CFTC's time, will give it more time do to that for which it was originally created back in 1974, i.e., the supervision of agriculture.

It could result, so the argument goes, in a better and cleaner agricultural market if this thing is taken away from the CFTC.

I wouldn't want to stake my life on that argument, but I thought I'd ventilate it.

Senator **Garn**. Well, let me characterize it this way, then.

As far as farmers are concerned, that it's more of a scare tactic, that it really doesn't directly affect—

Mr. **Eagleton**. Chicago has scared them, quite obviously. Chicago has sent out the alarm—hey, fellows, get behind us because they're after us; those nasty guys in New York that wear three-piece suits and went to Yale and Princeton and Harvard with Senator Heinz. [Laughter.]

Senator **Heinz**. It's bad enough to go to Yale and Harvard and Princeton. Don't saddle them with that. [Laughter.]

Mr. **Eagleton**. They're coming after us. New York's after us and they're going to take us all, lock, stock and barrel. So we'd better lock the door. Give them an inch and those guys will take it all.

So you've got those poor farmers in Des Moines and Omaha and southern Illinois, bringing in their pigs every night and saying, my God, Wall Street's after us. We've got to stop 'em. [Laughter.]

Senator **Garn**. I agree with some of your criticisms of the CFTC. But, on the other hand, why is the SEC better qualified?

After 16 years on this committee, Tom, I can give you a long list of failures of the SEC in things that I think they could have done much better as well.

WHY IS THE SEC BETTER QUALIFIED?

So let's assume for sake of argument the CFTC isn't the right one to do it. Why is the SEC?

Mr. **Eagleton**. I said in part of my earlier remarks that the SEC was not perfection personified. And these cases going in New York, and Boesky and all that, is certainly living proof of that.

All I'm saying is I think it's better to put this important regulatory jurisdiction into one cop's hands. And in this instance, the most seasoned, the veteran cop, that cop that has at least a modicum of public respect, i.e., the SEC. And to then supervise it and say, now, are you intelligently using that regulatory power, Mr. Chairman of the SEC, for the benefit of the investing public?

I cannot guarantee the SEC will do an absolutely perfect job. My guess is they would not do an absolutely perfect job, just as no other regulatory agency does an absolutely perfect job.

Senator **Garn**. Much of the debate centers around the issue of margins. And as you well know, unlike the securities market where margin levels are established by a governmental entity, in this case, the Federal Reserve, futures margins are set by private exchanges.

Why, for example, would margins, initial margins, requirements for speculators on the Chicago Mercantile Exchange climb from 4 percent a year ago to 11 or 12 percent today?

Mr. **Eagleton**. I don't know, sir. I'll have to plead nollo on that. I haven't got a satisfactory answer or sufficient expertise for that.

Senator **Garn**. I see my time is about up. I have no futher questions at this time, Mr. Chairman.

Senator **Dodd**. Thank you. Senator Riegle.

The **Chairman**. Senator Eagleton, let me ask you this.

MARGIN STRUCTURE OF THE TWO MARKETS

We have tried on numerous occasions to figure out how the margin structure works in the futures market versus the underlying stock market.

As you know, the different percentages of money have to put up to do the trades and so forth. But the argument is made that in the case of the underlying stocks, you have several days in which to pay for that transaction and close it out. And in the futures market, it's a daily close-out and you've got to settle your accounts at the end of the day.

I have asked any number of witnesses on both sides of this issue and outside experts to somehow cross-relate the way the margin practices affect these two markets.

What would, in effect, be an equivalence that would put these two markets on an equal footing if you take into account the difference in the one case where you've got a several day clearance period versus a daily clearance period?

And I don't necessarily, in posing the question, assume that you've been able to figure it out any more than anybody else I've asked. But to the extent that you have an opinion on it, I'd like to hear it.

Mr. EAGLETON. I've heard the arguments, Senator Riegle, as you very ably have set them forth. I am not enough of a technocrat to give you an answer on, to use your phrase, how they ought to cross-relate.

I'm willing to let Mr. Breeden do that on behalf of the SEC to determine that which is the most efficacious for the equities, and that which is proper for stock futures.

I can't give you an informed or expect judgment.

The CHAIRMAN. Well, in my opening statement, I made a reference to an advertisement that has been run by one group on this issue. They assert that, in October 1989, and during that market drop, an investor with $100,000 could have, under the margin requirements prevailing in the underlying stock market, used it to acquire $200,000 in stocks of one kind or another.

And an investor with the same $100,000, if they'd gone to the futures market, could have traded stock futures worth $4.4 million.

Is it your sense that those are the rough orders of magnitude in terms of how these differences in margin apply?

Mr. EAGLETON. Well, I'm sure your research is accurate. No one has up until now faulted——

Senator DIXON. Well, that isn't research, may the record show. It's an ad run as a full-page ad in the Wall Street Journal, the New York Times, and the Washington Post at the expense of several hundred thousand dollars by the New York street. It's not research.

I apologize for my interruption.

The CHAIRMAN. Well, not at all. I think the record will show that I didn't indicate it was. It's from an advertisement, as I stated. So I can't attest to the accuracy of the figure.

What I'm asking you is that, from your experience and proximity and vantage point, if it's your sense that you've got those kind of multiples in terms of leverages?

Mr. EAGLETON. I know the multiples are enormous. I cannot sit here and tell you how enormous they are. And I cannot precisely verify that ad, but I presume the witnesses will come along after me who will support the factual statements in their ads.

The CHAIRMAN. I'm also wondering, have you been able to think enough about this question of structure? I know you've made it clear that you support the recommendation of the administration.

Is there any other approach that's crossed your mind at any time that would be a jurisdictional arrangement that would be as good or maybe better to try to deal with some of the things that you're concerned about?

Mr. EAGLETON. Yes, kill the SEC. When I left Chicago, my last day there flying back on the plane, I said, what ought to be done to improve this situation? My first notion was just to blend the CFTC in its entirety into the SEC. Put futures, et cetera, up at the top with the rest of the SEC and put the CFTC as an adjunct, some kind of thing.

And after thinking about that for 5 minutes, and that was sort of neat and putting agencies together, that's deemed to be efficient and supposedly, you save money when you do that, et cetera, I've heard all those arguments, as have all of you, then I said, well, my God, a political turf fight over that. To collapse entirely the CFTC was politically unrealistic. So I dismissed that.

I testified in favor of the Leahy bill that Senator Dixon mentioned and said, I prayed and hoped that the CFTC got better and I hoped that the powers that were in that bill and the extra money, et cetera, improved it. It only had one way to go.

It couldn't get any worse.

The CHAIRMAN. But did I misunderstand what you said at the outset? You said, get rid of the SEC.

Mr. EAGLETON. Well, you said, did I have any other configuration of how this jurisdictional matter might work?

The CHAIRMAN. Yes. Right.

Mr. EAGLETON. And my initial gut response at one time was fold the CFTC in its entirety into the SEC. But then I disabused myself of that notion because I found it to be politically unrealistic.

The CHAIRMAN. Well, I think you may have misspoken when you started out by saying you thought the SEC should be done away with.

You meant the CFTC.

Mr. EAGLETON. I misspoke. I ask the record be changed.

The CHAIRMAN. So then you testimony today is that you have no other alternative in mind that you want to suggest to us beyond the one that's on the table that's been presented by the administration.

Mr. EAGLETON. This is the narrowest jurisdictional change that can have some significant enforcement meaning. Anything narrower would be just cosmetic. Anything broader would institute a political donnybrook of staggering proportions, as I see it.

So this is about the focus that is realistic, both in terms of enforcement and politically.

The CHAIRMAN. Very good. Thank you.

Senator DODD. Senator Heinz.

Senator HEINZ. Tom——

Senator DODD. Senator Kassebaum and Senator Shelby have arrived.

Do you have any opening statement?

Senator SHELBY. I have an opening statement. I'd just ask that it be made part of the record, Mr. Chairman.

Senator HEINZ. Tom, you have taken the position that the CFTC is a very weak and ineffective agency.

I believe you called it a pygmy agency.

I'd like you to elaborate a little bit more on why, over the course of a 15-year or more period since its creation, the CFTC hasn't been able to become a competent and effective regulator.

I'd like you to do so, quite obviously, because if it can't be a competent and effective regulator, it's got to be of concern to everybody, whether they're in Chicago or New York or the country at large.

CFTC IS AN INEFFECTIVE REGULATOR

Mr. **Eagleton**. Well, I'd give three reasons why the CFTC has failed or not been able to do its duty.

No. 1, it's a political dumping ground, and has been since its creation. And that was through both Republican and Democratic administrations. The last precinct captain in Iowa, dump him on the CFTC or something like that. It has never been a coveted agency with stellar performers.

No. 2, lack of monetary support in order to have adequate enforcement personnel.

CFTC has about 25 people that can respond to emergencies. Everybody else is tied down doing regular, routine, albeit, important paperwork. But you can't spare me. The forms are coming in. I've got to file them. I've got to put them somewhere.

About 25 people can look into something like that for the Ferusi scandal, if you remember that one.

No. 3, is what I referred to earlier. The CFTC has been the playtoy of Chicago.

Senator **Heinz**. Why is that? Is that related to the fact that they haven't had enough money and haven't had enough regulatory horsepower?

Mr. **Eagleton**. Well, up until now, unless the Leahy legislation has passed, they have to be reauthorized every 3 years.

I don't know of any other Federal agency—perhaps members of the committee can educate me—that has to come to Congress every 3 years to beg for its life. And in order to beg for its life, it's got to get Chicago to help them beg.

Senator **Heinz**. What effect has the lack of money had.

Mr. **Eagleton**. Yes.

Senator **Heinz**. Why has it been underfunded?

Mr. **Eagleton**. Because Congress, on the whole, and I told you, I was chairman of the Appropriations Subcommittee some years ago——

Senator **Heinz**. Yes. That's why I asked.

Mr. **Eagleton** [continuing]. It was an adornment. Nobody paid much attention to it. It was off by itself. There were other things more important that were on people's minds than going to the mat on how much money to give the CFTC. Oh, give them a couple extra investigators and shutup. [Laughter.]

Senator **Heinz**. On the question of margins, which Senator Garn and Senator Riegle asked you about, probably that is the toughest issue for the people in Chicago to come to grips with.

Senator Dodd suggested that maybe the Fed could do it, as opposed to the SEC.

My question to you is not who should do it, but why is there this pathological fear that if somebody other than the CFTC has margin oversight, that the entire financial futures operation in Chicago will go by the board?

And I don't think pathological is too strong a word.

Mr. **Eagleton**. It is a pathological fear. It's based on the fact that Chicago believes that the SEC is heavily influenced by the New York and American stock exchanges and thus, we'll bring pressure on the SEC to impose needlessly high margin requirements which Chicago believes would cause its financial detriment.

Senator HEINZ. Does that fear or belief extend to the fact that there isn't anybody any place other than at the CFTC who can do that and do it right?

Mr. EAGLETON. Run that again.

Senator HEINZ. What you said in your answer to me was that they are afraid that if the power goes to the SEC, the SEC, from their perception being a captive of Wall Street, will simply be insensitive and put them out of business.

Mr. EAGLETON. Yes.

Senator HEINZ. My question is, all right, so much for their fear of the SEC. But what about their fear of margin oversight being vested some place other than the SEC?

Is there no realistic alternative for them than the CFTC? Why do they think the CFTC is the be-all and the end-all, particularly after your characterization of it?

Mr. EAGLETON. They like it. They like this pygmy agency. They like an impotent, underfinanced, underenthused agency supervising their work.

They like it that way. They believe in self-regulation. And the CFTC is the living embodiment, as it were, of self-regulation by those who are to be regulated.

Senator HEINZ. Well, I think you're being in this instance actually modest and kind because, as I understand it, the futures operators in Chicago oppose the CFTC having margin oversight authority.

Mr. EAGLETON. Well, if it's to be put anywhere, that's where they'd like it.

Senator HEINZ. Yes. All right.

Mr. EAGLETON. It would be awful safe there.

Senator HEINZ. Tom, my time is expired. I just want to comment that you're very popular on the Republican side of the aisle, with the possible concern of Senator Bond being noted. [Laughter.]

And we have never had any problems with you making long speeches at our lunches.

Mr. EAGLETON. Thank you. [Laughter.]

I was not the wrong speaker for lunches.

Senator HEINZ. And I guess we never will.

Mr. EAGLETON. I won't say who was.

Senator DODD. Senator Sarbanes.

The CHAIRMAN. The record has to be corrected on that because that was one of those sort of—it was a very subtle joke that you have to have been part of the Democractic caucus to appreciate.

Eagleton was not one of the frequent talkers, and that's because there are others who are. Sometimes it's a little tough to get——

Mr. EAGLETON. Don't confess, Senator. [Laughter.]

The CHAIRMAN [continuing]. a word in edgewise. But it's sort of an in-house joke.

Senator SARBANES. Thank you, Mr. Chairman.

Your closing sentence in your statement says, "It makes no sense for equity or equity derivatives to be split into two varying regulatory playing fields."

Mr. EAGLETON. That's right.

Senator SARBANES. Now, accepting the premise of that statement, do you think that if that issue had been put in 1974, when the CFTC was established, at that time, the world of stock index and other financial futures was not on the horizon.

Mr. EAGLETON. Correct.

Senator SARBANES. Suppose it had been on the horizon. Do you think the CFTC would ever have been given jurisdiction over stock index futures?

Mr. EAGLETON. Never, You're correct. It was not on the horizon. Nobody had even thought about it. It was later sort of invented by Leo Melamed, who's a genius. I want to put that on the record. Probably one of the brightest men I've ever known.

He's brighter than Henry Kissinger even thinks he is. [Laughter.]

Senator SARBANES. I'm not sure that even Leo can meet that standard. [Laughter.]

Mr. EAGLETON. If that had come up in 1974 and we said, OK, we're putting butter and eggs and pork bellies here, and of course, the stock market is over here. Where are we going to put stock index futures? We'd have had a unanimous vote in the Senate.

It would have been 100 to nothing. Where are we going to put those stock index futures? Are we going to put those in with the butter and egg guys? No. That's Wall Street type stuff. Put it under the SEC.

It would have been 100 to nothing. There would have been no split between the farm States and the eastern seaboard establishment States. Never.

But now, possession—what's the old bormide? Possession is 9/10ths of the law—Chicago's got possession and they want the CFTC to continue the regulation.

Senator SARBANES. But it's your view that the connection, the nexus between stocks and stock index futures is far stronger than the connection between stock futures and commodity futures.

Correct?

Mr. EAGLETON. Certainly. Yes, I believe that to be the case, Senator.

Senator SARBANES. All right. Now, if you wanted to put them all together, what about putting stocks over in the CFTC? What's your reaction to that?

Mr. EAGLETON. Oh, my, my. Oh, no. [Laughter.]

No, the country couldn't take that.

Senator SARBANES. Why don't you develop a bit how the CFTC's involvement in stock index futures may in fact be impacting negatively on its ability to, in effect, serve agricultural interests?

Mr. EAGLETON. Well, I'll expand on it just briefly. What you ought to call is a very fine man that used to serve on the board who is a national cattleman. He felt deeply saddened because the discussions at the meeting are all about stock index futures and equity derivatives, because that's the hot stuff. That's big bucks. And cattle and those other things have just gotten further and further back.

It's just like the farmers out in Kansas who just feel that they are more and more forgotten, as America urbanizes and suburbanizes.

The same thing happened in the Chicago exchanges. They've gotten more stock index futures, as in S&P 500's, and less and less cattle.

I'm not saying that it's an irrelevancy. Don't get me wrong. It still brings big bucks into the exchange. But at the Merc the heavy focus is on S&P 500's.

Senator **Sarbanes**. I'm not familiar with the Ferusi fiasco. Could you elaborate on that?

Mr. **Eagleton**. Oh, my God. That Ferusi fiasco. What was Ferusi? It was a corner. It had a fancier name than a corner.

What was the commodity? Help me out.

Senator **Bond**. Soybeans.

Mr. **Eagleton**. Soybeans. I got so many commodities floating around in my head, I can't remember which one.

But, anyway, it was soybeans corner, and it didn't work. And Ferusi is the name of the firm, attempting the corner.

But, anyway, all hell was breaking loose. It was demanding an enormous amount of time from the CFTC and they didn't have the total time to give to it because they have this very tiny, disposable talent group that can shift from one problem to another. It's meager.

It's not like the FBI, and they've got their problems, I guess, too, that can pull together a task force to work on this or some other quickly emerging problem.

Senator **Sarbanes**. Now, I gather that one of the arguments that's being made to farm interests is that the Chicago firms make money out of the stock index future activity.

Mr. **Eagleton**. Sure.

Senator **Sarbanes**. If that jurisdiction is taken from them, while it's only a small percentage of their overall activity, it may be a much larger percentage of their profit-making activity, that they will lose that profit and then they'll have to build a higher cost into the balance of their direct commodity work, and therefore, a higher cost is going to be passed on to the farm community.

What's your response to that argument?

Mr. **Eagleton**. Well, the agony and worry is that, somehow, if this jurisdiction is transferred, the SEC is going to really sock it to 'em along the lines you're stating, and really crush 'em, almost put them out of business in terms of these index futures. And thus, they'll be left only with their traditional base.

Plus, they've got all these currencies that are relatively of modern origin that they trade in Swiss francs and Deutschmarks.

But there is that worry that the SEC is going to somehow put them out of business.

Now, I don't think that it is as day follows night that if this jurisdiction is transferred, as proposed by the administration, that it means the demise of stock index futures, as is predicted in Chicago. I don't think that's the case.

I don't think the SEC wants to put them out of the business. I think you have the Brady Commission report—index futures serve a legitimate purpose in the marketplace.

I don't know if you'll have any witness here that will testify before you and say they ought to be totally put out of business. I don't think there's anybody that I've heard of that holds that viewpoint.

Senator **Sarbanes**. Well, some of the fast operators ought to be put out of business.

Mr. **Eagleton**. Yes. Sure, there are abusers. Sure, the abusers ought to be put out of business.

Senator **Sarbanes**. All right. Thank you, Mr. Chairman.

Senator **Dodd**. Thank you, Senator Sarbanes.

I just want to point out, Tom, the subcommittee, in conjunction with the full committee and others, is trying to collect as much data as we can on the margin issue.

It's a massive undertaking. This is not an easy thing.

Mr. **Eagleton**. I'm sure that's the case.

Senator **Dodd**. Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator **Bond**. Thank you very much, Mr. Chairman.

Tom, it's always a pleasure to have you back here, adding your insights from the other side of the table, I might say. We've had a chance to discuss these issues in the Agriculture Committee as well.

I don't think this is the place to go into it, but as we look in the CFTC oversight with respect to the attempt to corner the soybean markets, or the CFTC unravelling of the Ferusi contract in soybeans, I'm not sure that we came to the same conclusion, that the CFTC did not in fact handle that measure well.

I think that there have been some changes in the CFTC in recent years. I think that Chairman Gramm has brought a new level of leadership and dedication to the CFTC.

So, while I would agree, and I'm going to agree with a number of your points about the impact of CFTC or the impact of the stock index futures on the underlying stocks, I would have to separate myself a bit from your overall conclusions about the CFTC.

I share your desire to see the CFTC strengthened and I hope that we can resolve this matter that's before us and get on with the reauthorization bill because that, too, is important.

Now, I think that, as I looked at this issue from both sides of the spectrum, I think that the volatility is the thing that has caused the most concern.

And as I've talked with Secretary Brady and others, I've gotten a very clear message that they think the margin level going into October 1987, in particular, was the thing that enabled the creation of such wide swings in the futures market.

There are problems with intermarket front-running. But as we went back and reviewed what happened in 1987, some of the most egregious intermarket front-running came not on the Chicago or other U.S. exchanges, but in London. Exchanges for physicals enabled major trading firms to come into the market with stocks in hand Monday, October 19, and pound the market down. A transfer of jurisdiction from the CFTC to the SEC is not going to deal with that problem.

We have got to have a better coordination internationally because it's not just the futures market here in the United States that caused the problem.

I think that we have to address the concern over the volatility that highly leveraged futures dealings in equity derivatives brings to the overall market and the impact it has on investor confidence.

I'm sympathetic, very sympathetic to the administration's proposals, although I'd add one very important point that I think should be considered, and that is the impact of dual regulation on the smaller exchanges. That could put some in a very precarious position.

And if you're thinking I'm talking about Kansas City, you're right. There are some problems that would have to be addressed in the Kansas City exchange situation.

But as far as the administration's proposal is concerned, I'm still a rookie around here and I'm not nearly as good at counting votes as you are. But I have the very strong suspicion that there are not the votes to accomplish that right now.

As we say back home, I don't think that dog is going to hunt. It's not going to hunt this year.

Therefore, I am very much concerned to address the problems that the chairman has addressed here, that Secretary Brady has addressed, and that is the volatility that comes about from the margins.

And it's for that reason that I think that a compromise position, at least for the interim, to move the margin function to the Federal Reserve, which could then delegate it to the CFTC, as the Federal Reserve delegates the stock margins to the SEC, may be an important step to avoid a volatility-induced downturn.

I would be interested—I got the drift of what you said earlier, that making three instead of two traffic cops would be bad, would be even worse.

But I'd ask you to rethink that and see whether there is possibly room if we can get something done—is that a worthwhile partial step, or do you see that as totally ineffective?

Mr. Eagleton. Well, I think you've made some excellent points, Senator Bond.

First of all, my complaint on Ferusi was not so much that they didn't handle it so well, but it totally tied up the CFTC's investigative force. If there had been another slight glitch anywhere else in America that was under the CFTC's jurisdiction, they would not have been able to handle it because of the shortage of trained manpower. All the CFTC had was being applied to Ferusi.

As to your volatility issue, obviously it's an essential part of the problem that has to be dealt with. And as to your head count and you say this can't be done, but maybe something else in the interim can be—you gentlemen are alive. I'm politically dead. You amongst the senatorial living and breathing can do a lot better head counts than I can.

Maybe your final suggestion is that this is the only thing that's viable. I'd like to think about it. But I'll leave the head-counting to you all.

Senator **Bond**. I appreciate that answer. But I see that I've run out of time, so I won't go into discussing the Cardinal baseball situation with you until after this hearing.

Thank you, Mr. Chairman.

Senator **Dodd**. Thank you, Senator Bond. I appreciate you bringing up the point about the Fed, which I raised earlier. The Federal Reserve has margin authority for stock and delegates margin authority over stock options to the SEC.

So there is a role there for the Fed already. That's a good point that you're raising.

Senator Dixon.

Senator **Dixon**. Thank you, Mr. Chairman.

Tom, I just want to talk to you about several of the points you made.

First of all, there's a lot of talk here about one regulator, the importance of having one regulator. In the last decade, FSLIC was one regulator over the thrifts in America. There were three regulators over the banks.

I would submit to you, Tom, one regulator doesn't always get a dynamite result. I think the result of FSLIC regualtion of the thrifts for the last decade speaks pretty eloquently to the fact that one regulator doesn't always get the job done.

Mr. **Eagleton**. Well, Senator, there was FSLIC, and wasn't there also the Federal Home Loan Bank Board?

Senator **Dixon**. Well, that's part of it.

Mr. **Eagleton**. Part of it. We might have been better off if—what do we have now? We do have one agency now that in its wisdom——

Senator **Dixon**. Well, we have the Resolution Trust Corporation and I guess the OTS. And we're not doing too well right now, may I say.

Mr. **Eagleton**. Mr. Seidman was appointed the great impresario of the whole thing.

So the decision that was made—it's one of the most recent decisions made by Congress—was to put it in the hands of one regulator, one czar.

Senator **Dixon**. Now, when you talk about the SEC and the grand job you believe will be done by the SEC, it strikes me that the evidence is not so overwhelmingly positive in that regard.

I'm looking at the result of the first case tried out in Chicago in connection with that market, which is under the jurisdiction of the CFTC. Tried three people—acquitted one. The jury on Monday found the other two guilty of eight counts of stealing $200.

I think that speaks fairly eloquently in comparison with the Levines, the Millikens, the Boeskys, and others who stole billions on Wall Street with the jurisdiction of the SEC involved there. And I wonder how you make that comparative analysis.

Mr. **Eagleton**. First of all, I've said at least on three occasions, and so I think this will be the fourth occasion, I do not view the SEC as perfection personified.

There have been miscreants through the years while the SEC has been on the books. So their record is not immaculate.

Senator **Dixon**. Well, would you concede more, more egregious, more onerous, more terrible abuses?

Mr. **Eagleton**. I would concede this, Senator Dixon. You come over to St. Louis a lot more. Glad to have you at the baseball games.

Senator **Dixon**. Thank you.

Mr. **Eagleton**. You go to any of the major stock brokerage firms in St. Louis and you sit down and you talk to the stockbrokers and say, hey, compare me the quality of enforcement by the SEC with the CFTC. And they'll tell you unanimously, they'll tell you unanimously that the CFTC ain't up to the job.

Senator **Dixon**. Well in looking at the futures industry report, it says that right at this moment, 58 percent of the people on Wall Street under the SEC are very concerned with the honesty and the ethics of brokers.

Mr. **Eagleton**. Well, the next question down, I think, is what do you think of the CFTC? And it says, 100 percent of the people think it's a bunch of dupes. [Laughter.]

My edition of the paper has a more complete story.

Senator **Dixon**. Tom, you're a pal, but you made that one up. [Laughter.]

You made that one up, Tom. You say there's three things wrong with the CFTC.

It's a political dumping ground. Well, the man who has advocated all of this legislation that you support, my friend, Nick Brady, your friend, his history—a Wall Street investment banker advocating the position of Wall Street in this legislation. Handled the campiagn for Bush in New Jersey, became a U.S. Senator of the Republican persuasion by appointment. Was appointed Secretary of the Treasury.

I don't have any problem with any of that. Do you think there's any politics in that?

Mr. **Eagleton**. Mr. Brady comes out of politics. He'd be the first to admit it. And also investment banking.

Senator **Dixon**. Well, let's talk about the Cabinet. The top job, Secretary of State—Jim Brady. Treasury—Baker. Defense—Cheney.

All my friends, all nice people. Would you say they had a political background?

Mr. **Eagleton**. Well, give me the background of the members of the CFTC and see how their names ring out in the lexicon of brilliance of Amerian politics, Government, and the political process.

Senator **Dixon**. Well, I don't know that a name being known is necessarily an indicative thing about brilliance, necessarily.

I think, incidentially, the men I've mentioned are decent, bright men. I don't mean to denigrate them by suggesting they have a political background.

The second thing you said is inadequate money.

Mr. **Eagleton**. Yes. True.

Senator **Dixon**. Are you aware that S. 1729 on the floor of the U.S. Senate, being held up by administration, being held up by the people that endorse your position, raises the authorized amount this year to $65 million, increases it by $25 million annually in the next few years, puts in more money?

Mr. **Eagleton**. Yes. I testified in favor of that bill with one addition, Senator, so that the record is straight. The addition is that the CFTC must be obliged over 5 years to go to a fully electronic system and plug up the open out-cry, Mack truck loophole, because that is the major source of the evil in Chicago. Open out-cry.

Senator DIXON. You would dispute that most of the electronic systems and advances in those systems have been created in Chicago?

Mr. EAGLETON. Indeed. And if Chicago can create them for Singapore, they can certainly use them in Chicago. That's my very point.

Senator DIXON. Well, good.

Mr. EAGLETON. Why can Chicago create an electronic system for the whole world except itself?

Senator DIXON. And they are creating them and have been working in cooperation with the CFTC in the improvement of their system.

Mr. EAGLETON. But the bill leaves a loophole, Senator. And in the committee report, for some reason, someone wrote in the committee report, there shall never be a fully electronic system in Chicago. Open out-cry shall always be maintained.

It's in the committee report. Strangest thing I've ever read.

Senator DIXON. Now with respect to Chicago's influence over the CFTC, you attribute some of that to the necessity for reauthorization.

So let me review all that.

Are you then disputing the fact that a CFTC could not be so constituted that it would be an effective functionary body; that is to say, if it was permanently authorized, which, incidentally, this Senator has no problem with—nobody ever came to me and said, don't ever permanently authorize the CFTC.

We're trying to reauthorize it and now we can't get it set for reauthorization.

This Senator has no problem with reauthorization. This Senator has no problem with adequate money to do the job. And may I say, this Senator has no problem at all with seeking out the best qualified personnel in the country to be on the CFTC.

And so I put it to you, all those things being a fact, if they were a fact, then why couldn't the CFTC function in a category that would satisfy my friend from Missouri?

RISK OF SCANDAL IN CHICAGO

Mr. EAGLETON. I think the Leahy-Lugar bill to which you're referring, would be a considerable step forward in enhancing the regulatory powers of the CFTC in the areas that you've just mentioned. It's authorized permanently, unless othewise rescinded, additional moneys, et cetera.

It does have this glaring loophole for open out-cry, which means that the risk of scandal in Chicago will always be high.

I cannot say that enough because that is the God's truth. Now——

Senator DIXON. You think the risk of scandal in Chicago is higher than the risk of scandal in New York, my friend?

Mr. EAGLETON. I have never served on the board of governors of the New York Stock Exchange. I'll be glad to go up there and serve on it.

Senator DIXON. Well, I'm interested in knowing whether you have that view.

Mr. EAGLETON. But I'll tell you, the risk of scandal in Chicago is enough to cause me to quit.

Senator DIXON. And the risk in New York, you think, does not exist?

Mr. EAGLETON. I haven't served on the board, Senator. I'll be glad to make a judgment if I served on the board. I have served on the board of Chicago Mercantile.

Senator DIXON. Well, you know about the Boeskys and the others that I mentioned before that are headlines in every major periodical in the country, do you not?

Mr. EAGLETON. I said that they're not perfection personified. I'm not here testifying for Mr. Boesky or Mr. Milken or Mr. Anybody. I'm here testifying for myself.

Senator DIXON. I understand that.

Mr. EAGLETON. I'm here testifying based on my knowledge in having served 3 years on the board of governors of the Chicago Mercantile Exchange.

If I have an expertise, that is it.

Senator DIXON. But you do not come to this committee to contend that there is any unusual underlying characteristics that require a different degree of attention there, which is to say that one good regulatory agency with good people, in the view of this Senator, is as good as another.

I want to see whether the other Senator at that table who has served here with great distinction in the past feels differently.

Mr. EAGLETON. Even if you were to pass the Leahy-Lugar and then improve the statutory status of the CFTC, I would still favor what is being proposed here today in the interest of one-cop uniformity to try to help avoid calamitous events such as 508 in 1987 and 180 or 190 in 1989.

Senator DIXON. I wonder if you were aware of the things developed at the hearing on that question, incidentially, where it was pretty clear, I thought, that the SEC did not act very effectively on that occasion.

Mr. EAGLETON. I don't think anybody wins a great award because there is divisions between the SEC and the CFTC. They couldn't agree on circuit-breakers, they couldn't agree on this, they couldn't agree on that. Nature took its course. And nature was 508, in one instance.

Senator HEINZ. Mr. Chairman, I'd just like to correct the record, if the Senator from Illinois would permit me.

Senator DIXON. Oh, I would be delighted. As a matter of fact, the Senator from Illinois has concluded.

Senator HEINZ. Well, the Senator from Illinois indicated that either Republicans or the Administration were holding up the passage of the CFTC reauthorization and——

Senator DIXON. Well, as a matter of fact, the Senator that's addressing me is the one who put a hold on it on at least one occasion that I'm personally aware of.

Senator HEINZ. If the Senator would allow me to finish.

Senator DIXON. I'll be delighted.

Senator **Heinz**. Since he was kind enough to yield in the first place.

Senator **Dixon**. It's my pleasure to yield and my pleasure to listen.

Senator **Heinz**. It is quite true that the Senator from Pennsylvania has had a hold on that bill for about 4 weeks.

Senator **Dixon**. Thank you for acknowledging that.

Senator **Heinz**. And I would like the Senator from Illinois to tell the Recording Clerk how long he had a hold on the bill.

Senator **Dixon**. Well, the Senator from Illinois has been trying to get at the bill for a long time.

Senator **Heinz**. As I understand, the Senator from Illinois had a hold on the bill for 6 months.

Senator **Dixon**. No, the Senator from Illinois did not have a hold on that bill for 6 months.

Senator **Heinz**. Then maybe he will tell us how long he did have a hold on the bill.

Senator **Dixon**. The Senator from Illinois would like to vote on the bill today.

Senator **Heinz**. Then maybe he would tell us how long he had a hold on the bill, if he's going to say that other people had holds on the bill.

Senator **Mack**. Mr. Chairman.

The **Chairman**. I think in the order of things—[laughter]—with that having been said, back and forth, that Senator Mack is now recognized for his questioning.

Senator **Mack**. I have just been informed that I have to leave. [Laughter.]

But I couldn't pass up this opportunity to tell Senator Eagleton and my colleagues how relieved I am today to have found out, after almost 3 years of carrying around this terrible weight on my shoulders, that I am not responsible for the 508 that you've been referring to. [Laughter.]

You see, on October 19, 1987, I was announcing to the State of Florida that I was going to run for the U.S. Senate.

I started out down in Key West, FL, and by the time we got back to the plane to head to Orlando, the market was down 100 points. I was a little bit concerned, but we continued on, went to Orlando, made the second announcement of the day, went back to the car to make the drive to the airport to go to the St. Petersburg area, and found out the market was down 200 points.

At which I began to question whether I should continue with the announcements for the day. [Laughter.]

Went on to St. Petersburg, made the announcement. The market was down 300 points.

Went to Ft. Myers, FL, made the fourth announcement. The market was down 400 points.

Fortunately, I only had one more stop to make. And that was in Tallahassee.

So I am relieved to find out that it was not me and it was the margins and the CFTC.

Unfortunately, I do have to leave and I will try to get back to listen to the balance of the testimony.

Thank you.

Mr. **Eagleton**. Thank you, Senator.

The **Chairman**. Senator Shelby.

Senator **Shelby**. Tom, let's get back into volatility just a minute because I think that is central to what we're getting at, one of the central points.

VOLATILITY IN THE MARKET

If the laws were changed and you had SEC jurisdiction, one traffic cop, as you say, does that do away with the problem of volatility in the market?

I'd say, no. Do you agree?

Mr. **Eagleton**. Probably not, in and of itself, no. I think Senator Bond made a valid point.

Senator **Shelby**. OK. But so many of the proponents—I wouldn't say Secretary Brady because I hadn't talked to him at length about this. But other people that have been coming to me and talking to me about it, say, look, we've got to do something about volatility. We can't let October 1987 happen again.

But this wouldn't necessarily preclude that. You know that.

Mr. **Eagleton**. This is not a panacea, Senator.

Senator **Shelby**. It doesn't cure it. It would just bring about——

Mr. **Eagleton**. I think it's a significant improvement, but not a panacea.

Senator **Shelby**. Improvement in what way?

Mr. **Eagleton**. Improvement in regulatory supervision and enforcement, the one traffic cop thing.

Senator **Shelby**. Because of one cop.

Mr. **Eagleton**. The one cop. One set of ground rules, one playing field over the securities that, if not identical, are so closely related as to, at least in the public's mind, be identical.

Senator **Shelby**. Let's talk about the public's mind a minute.

What a lot of people have said, the proponents of the SEC one cop jurisdiction have said, we've driven the little investor, the small investor, the small businessman, and so forth, out of the market.

Mr. **Eagleton**. I think there's some numbers to back that up.

Senator **Shelby**. But if we had one traffic cop and they come back into the markets, and then you have this volatility again, isn't this misleading them?

Mr. **Eagleton**. Well, Senator, I don't believe that if this bill is enacted——

Senator **Shelby**. I didn't say you would. I'm just saying wouldn't the fact mislead them some?

Mr. **Eagleton**. Let me respond.

Senator **Shelby**. Sure.

Mr. **Eagleton**. I don't think enactment of this one bill would open the floodgates for millions of small investors to immediately return to the market and say, God, now we're protected for sure. We're safe as safe can be. Congress has acted. We're going to reenter the market.

It's not going to be that way.

Senator **Shelby**. It doesn't work that way.

Mr. EAGLETON. It doesn't work that way. It will, I think, improve some investor confidence, but not open floodgates of new investors or the reintroduction of old investors.

Senator SHELBY. What about the markets going overseas? Let's say you had one traffic cop here. What's going to happen? There's going to be a market for these kinds of products and so forth. Would one traffic cop in the United States, the SEC, regulate global stock index futures? They couldn't.

Mr. EAGLETON. Well, again, a good point by Senator Bond. I hope I'm not building up his reelection campaign. [Laughter.]

Senator SHELBY. Well, you'll help him, sure.

Mr. EAGLETON. But he points out that London played a role in the October 19, 1987 disaster. I'm sure his facts are accurate. And we do not have jurisdiction over London or Hong Kong.

Of course, Senator, that argument about what's going to happen in the world, it also is used—we ought to do away with the minimum wage because, you know, they've got a lot of sweatshops over there in the People's Republic of China and we're competing with those. Let's do away with the minimum wage.

Or let's do away with this. Let's make America just like the least regulated, cheapest, sleaziest part of the world. Whatever is the level of sleaziness, that's our level, because that's international finance.

Is that our standard? Is our standard always the lowest common denominator?

Senator SHELBY. We're talking about technology moving across boundaries now, not the minimum wage.

Mr. EAGLETON. Well, but, no, that's the level of this argument, that we're got to worry about the PRC, so we'll pay people the lowest wage possible because we want to be like the rest of the world.

Senator SHELBY. This technology is going to be with us.

Mr. EAGLETON. Hong Kong may do a lot of cheating. Singapore may do a lot of cheating. Maybe they're going to have different margin requirements in those markets.

Must we hold ourselves to the lowest standard?

Senator SHELBY. We're not talking about that.

Mr. EAGLETON. The lowest of national respectability to meet competition?

Senator SHELBY. You might be talking about that.

Mr. EAGLETON. You don't mean that. You really don't.

Senator SHELBY. What we're talking about is technology moving across into other countries. And you know that will happen, and I do, too.

We're not talking about people being sleazy in the business. I agree with you. We need to eradicate all of that.

One last question. Senator Dixon brought up the magnitude of the scandals in New York versus the magnitude of the scandals in Chicago.

I don't want it to happen anywhere. You don't—anywhere, any time. And we need to get rid of it.

But does Chicago, or does it not, pale compared to what happened on Wall Street? I don't know. I would be interested in the magnitude of the scandal. Are we talking about billions of dollars in Chicago? Are we talking about $200 or $2 million and billions of dollars in New York?

I don't know. But I think we should look into this.

Mr. **Eagleton**. I don't know how to evaluate comparatively the scope of the illegalities. I know what Mr. Boesky was fined, et cetera.

Senator **Shelby**. Sure.

Mr. **Eagleton**. I know two out of three people were convicted. If they serve 5 years for stealing $200, to them it's going to be just as bad if they serve 5 years for stealing $200,000. Five years is hard time, you know.

There have been 48 indictments. We don't know how many are going to "flip" and turn government's evidence.

So we don't know where the prosecutorial trail's going to lead. I'm sure the U.S. attorney in Chicago is not elated. But I'm also sure those two guys that got convicted, two out of three, they're not elated, either.

They're most likely going to the pokey.

Senator **Shelby**. But the bottom line is, whether it's New York or Chicago, we're interested in honesty, aren't we?

Mr. **Eagleton**. That's right. Sure. Where we can find it.

Senator **Shelby**. Thank you. My time is expired.

The **Chairman**. Senator Kassebaum.

Senator **Kassebaum**. Thank you, Mr. Chairman.

Most of the questions have been asked. But I just want to say, Tom, it's such a pleasure to have you here and have a witness who certainly isn't wishy-washy. [Laughter.]

I value your insights. I think that many of us have raised the question of concern about volatility. And that certainly has concerned me.

I'm sorting through whether I think change of jurisdiction solves that.

You mentioned the Leahy-Lugar bill you thought was a good bill if it phased out the open out-cry.

Mr. **Eagleton**. Added to what already is in it.

Senator **Kassebaum**. Right. But, of course, that's, as you well know, an emotional minefield that I just doubt that we're going to do anything about at this point.

We ought to, I think, begin to think about it perhaps more and raise the issue more than we have.

It seems to me that, clearly, and Senator Bond was talking in exchange with you about vote count. I don't know how it goes, but I think that there are some opportunities for compromise without getting into this jurisdictional question.

Whether, indeed, it provides an answer, I'm not sure. But I just welcome your insight into this. It's been very enlightening, I believe, to hear from you who have served, who care about the honesty of the system, whether it's Wall Street or Merc, and the whole question of the volatility of the markets.

The trouble with us so often, as you well know, is to solve a problem, we sort of race ahead and maybe create three others along the way. And I guess that this is something that really concerns me with this issue, that we have some sense of where we're going and why maybe it's better to do it in small steps before we do a complete overhaul.

Mr. **Eagleton**. Two points in response, Senator Kassebaum.

No. 1, I agree with you. This bill is not a instant, total, complete cure.

No. 2, it may well be so politically hazardous that it's not passable.

As to a compromise, something in between, a meeting of the minds, I haven't given that enough thought to be of any use to you to suggest one here today. Perhaps there is one.

There are many good minds on this committee, and if there is one, I'm sure they'll find it, including yourself.

Senator **Kassebaum**. I would just like to put in a word on behalf of the CFTC board. I do think that, on the whole, certainly the board, as it's constructed today, I believe is a very fine board.

There happens to be a Kansan serving on it, that I have just enormous respect for his insight and ability.

So I don't think—I would take exception to it being a dumping ground.

Mr. **Eagleton**. OK. Well——

Senator **Kassebaum**. Because I think the CFTC's faults don't lie with the board. I think it realy does lie perhaps with how this whole question of the stock index futures, has grown and become such a key part of what was once just a commodities future exchange. And that the mechanisms perhaps have not advanced with the whole change of scenario.

Saying that, I thank you very much for being a very interesting witness.

Mr. **Eagleton**. Well, thank you, Senator. Your point is well taken. I do sometimes speak with a degree of exuberance. [Laughter.]

Thank you, Mr. Chairman.

Senator **Dodd**. Tom, we thank you for being here.

Just in summation, listening to your comments this morning, your first point is that this is not a minor issue. This is a serious question.

There's a tendency to sort of look at this as sort of an esoteric, narrow question. your point is that this is—it may be esoteric because of the fact that most people don't understand it fully. But your point is that this is an issue that, while it may seem minor to the outside observer, the implications of it are far-reaching.

That would be the first point you make.

And second, with respect to our failure to do something about this. It's one of those issues that people may raise the question of why we didn't do something when we knew we should have.

There was all the information out there, all the studies. Everything told us that our failure to act here could create a significant financial problem for this country.

Do you agree with that?

Mr. **Eagleton**. You put it very well. I wish I had said it just that briefly.

Senator **Sarbanes**. Mr. Chairman, could I put a question to Senator Eagleton before he departs?

Senator Dodd. Certainly.

OPEN OUT-CRY SYSTEM

Senator **Sarbanes**. Is there any rational reason that you know of why an open out-cry system should be maintained instead of moving to a modern, verifiable, electronic system?

Mr. **Eagleton**. Senator, in this day and age of electronics, with all these things that can be done electronically and, indeed, trading around the world 24 hours a day is going to be done and is being done electronically—with all of that, you can devise an electronic trading system for Chicago.

It is just ludicrous. It is ludicrous in the xtreme to say we'll have it electronically everywhere but Chicago. Chicago's going to remain in the horse and buggy age because that's the way we've always done it out here.

That's the only argument that they have in favor of keeping it—pious tradition. And it's this big, big loophole which this Mack truck made in your State can drive through and is driven through every single day on the floor of the Chicago exchanges.

Senator **Sarbanes**. Mr. Chairman, I just want to observe that there's been talk here this morning of New York versus Chicago and Wall Street versus LaSalle Street.

The address of the SEC is Washington, DC. And the address of the CFTC is Washington, DC. And their charge in each instance is the public interest.

And it seems to me that if, in the end, we conclude that the need to link equities and equity derivatives in terms of a regulatory jurisdiction as the overriding principle, then we're confronted with placing it in an appropriate jurisdiction.

That means members would have to ask themselves, well, do they want the CFTC to take over the stock jurisdiction or do they want the SEC to take over the stock option jurisdiction?

I think putting the question that way might well answer it for itself.

Thank you.

Mr. **Eagleton**. Thank you.

Senator **Dodd**. Thank you. Thank you very much, Tom. We appreciate your being here.

Our second panel this morning, and I'd ask you to join us as I read your name, is: Joseph Hardiman, president of the National Association of Securities Dealers; Jim Jones, a former colleague, the chairman of the American Stock Exchange; and Wayne Luthringshausen.

Did I pronounce that correct?

Mr. **Luthringshausen**. Very good, Senator.

Senator **Dodd**. Mr. Luthringshausen is the chairman and chief executive officer of the Options Clearing Corp., Chicago, IL.

We thank all three of you for being with us this morning. You may have heard me say earlier, we anticipated that this panel would be a bit larger. But we decided that it would make more sense to try and do this the way I described earlier, and that is to have you supporters of the administration's proposal here this morning and then the third day we'll have people from the Chicago community here to testify.

So we appreciate your willingness to be with us. Your formal remarks will be included in the record as if read. I would ask you to try and keep your prepared statements to a minimum, if you can, so that we can get to the questions.

But we thank all three of you for taking the time to be with us this morning.

We'll begin in the order that I've introduced you.

Mr. Hardiman, welcome.

STATEMENT OF JOSEPH R. HARDIMAN, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS, WASHINGTON, DC

Mr. **Hardiman**. Thank you, Senator.

I'm Joseph R. Hardiman, president of the National Association of Securities Dealers, the NASD. I'm pleased to have this opportunity to appear before you today to discuss the issues involving the administration's legislative proposal, the Capital Markets Competition, Stability, and Fairness Act of 1990, and to underline our strong support for this needed legislation.

Unlike other members even of this panel today, the NESD does not have any direct beneficial interest from the reforms contained in the administration's proposal. The markets that we regulate and that we operate do not have indices on which there are futures options contracts. We have not introduced products that have been rejected by the courts on jurisdictional grounds. We do not have, nor do we espouse, circuit-breakers that kick in at predetermined levels of market volatility.

What we do have, however, and what we do do is we oversee the trading of securities of a large number of rapidly growing companies whose timely access to capital at competitive costs and whose dependence on individual investors is closely tied to stability and confidence in the Nation's capital markets.

The current scheme of split regulation of stocks and stock index futures hampers intermarket enforcement, as we just heard from Senator Eagleton. That impacts investor confidence in the markets for both products that I would suggest.

The regulation scheme has not generated effective, coordinated circuit breakers for those markets that do have such mechanisms. It has not fostered comprehensive regulation and coordination of the clearance and settlements systems.

These systems were so strained during the 1987 market break, that the GAO stated that if the decline had, and I quote, "continued for even another day, massive disruptions to the U.S. financial system might have occurred."

Obviously, something has to be done if we are to regain investor confidence in the markets.

The NASD recommends the transfer of jurisdiction over stock index futures to the SEC because it has the broadest experience in regulating stock and stock-derivative markets. It has been charged by Congress since 1934 to assure that those markets not only operate in a fair and orderly manner, but also for the protection of investors. And it has carried out that responsibility, I would suggest, on balance, very effectively.

Indeed, in our judgment, the investing public will be reassured to know that at all times, not just at times of market stress, there is one agency at the Federal level charged with overseeing all aspects of the single market for stocks, stock options, and stock index futures.

Another area of concern of the NASD and others who are interested in the stability of the securities market is the appropriate level of margins for stock, stock options, and stock index futures, and the need for a coordinated approach to the establishment of such margins.

This does not imply equity of margins, but, rather, the need for consistency in the application of the standards used to determine appropriate margin levels, whether they be for determining the amount of leverage that can be used to acquire control of financial assets or for prudential purposes to protect the financial assets or for prudential purposes to protect the financial integrity of market participants.

The NASD shares the view of the Federal Reserve Board, the Department of the Treasury, and the SEC that Federal oversight is appropriate to ensure that margins on stocks, stock index futures, and stock options are established at levels that are adequate under a full range of market conditions.

To achieve this needed consistency, we further believe that this oversight should be vested in the one federal agency that already has authority for two of the three interrelated products involved, and that is the SEC.

The NASD supports the provision of the administration's proposal to modify the exclusivity clause to allow instruments with both futures and securities characteristics to trade on both the securities and futures exchanges, and we see this as crucial if we are not to abandon these products to our competitors overseas.

The administration's proposed legislation is good public policy. It would promote the safety and soundness of the securities markets which are one of our Nation's strongest assets. It would solve problems that come from fragmented regulation. It would help promote stability in the equity markets. And it would be a positive step toward restoring confidence of investors in our securities markets.

After the market break of 1987, the reforms contained in this legislation were identified by many parties as necessary. Three years, and several market events later, these reforms are still waiting, market instability is still present, and individual investors have yet to return to the market in significant numbers.

We urge the Congress to listen to the warnings the market has been giving us in these past 3 years and to pass this critical legislation now.

Thank you for your attention, Senator, and I'll be happy to answer any questions you may have.

Senator TODD. Thank you very much, Mr. Hardiman.

Jim, we welcome you this morning, a former colleague, former chairman of the Budget Committee in the House, someone I had the pleasure of serving with in the Congress of the United States for a number of years. We're pleased that you're here with us this morning, and we'll be more than happy to accept your testimony.

[The complete prepared statement of Joseph Hardiman follows:]

NASD

Testimony of Joseph Hardiman
President
National Association of Securities Dealers

Before a Hearing of the

Committee on Banking, Housing, and Urban Affairs
United States Senate

Concerning

The Capital Markets Competition, Stability, and Fairness Act of 1990

July 11, 1990

I am Joseph Hardiman, President of the National Association of Securities Dealers, Inc. (NASD). I am pleased to have this opportunity to appear before you today to discuss the issues involving the Administration's legislative proposal, "The Capital Markets Competition, Stability, and Fairness Act of 1990", and to underline our strong support for this needed legislation.

The NASD supports this initiative in its capacity as a national securities association registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, and as a member of the Ad Hoc Coalition for Intermarket Coordination. The Ad Hoc Coalition is composed of most of the securities self regulatory and clearing organizations. Although we are in many respects business competitors, we have joined together to address the problems of fragmented regulation of the markets for stocks, stock options and stock index futures, and of barriers to innovation and competition in these markets.

Unlike other members of your panel today, the NASD does not have any direct beneficial interest from the reforms contained in the Administration's proposal. The markets that we regulate and operate do not have indices on which there are futures or options contracts; we have not introduced products that have been rejected by the courts on jurisdictional grounds; and we do not have, nor do we espouse, circuit breakers that kick in at predetermined levels of market volatility. We do, however, oversee the trading of securities of a large number of rapidly growing companies whose timely access to capital at competitive costs and whose dependence on individual investors is closely tied to stability and confidence in the nation's capital markets. We support the Administration's proposal because it is good public policy: it would promote the safety and soundness of the securities markets, which are one of our nation's strongest assets; it would solve problems that result from fragmented regulation; it would help promote stability in the equity markets; and it would be a positive step toward restoring confidence of investors in our securities markets.

The NASD has not come by these views only recently. In March 1988, based on our review of the problems posed by the 1987 market break and the studies that resulted from that unsettling event, the NASD put forward several recommendations, which we have since reiterated a number of times in letters and testimony to both the House and Senate. Those recommendations called for:

- Regulatory authority for equity and equity derivative instruments to be vested in a single agency at the federal level (namely the SEC)

- Relative margin levels for equity and equity derivative instruments to be made consistent across all marketplaces; and

- Clearing, settlement, and payment systems to be coordinated across marketplaces to reduce financial risks for all market participants.

Your invitation to testify today asked the major questions that must be considered in your review of this legislation:

- Is there a need for one regulator of stock and stock derivative instruments?
- Which federal agency is appropriate to regulate stock index futures?
- To what extent, if any, does the current system of margin regulation for stock, stock options, and stock index futures contribute risk to the financial system?
- Should there be federal regulation or oversight of stock index futures margin?
- Comment on the need to modify the exclusivity clause of the Commodity Exchange Act to allow instruments with both futures and securities characteristics to trade concurrently on securities exchanges and commodity markets.

The NASD

The NASD is the only entity registered with the Securities and Exchange Commission as a national securities association under the Securities Exchange Act of 1934. It is charged with the responsibility of regulating both the National Association of Securities Dealers Automated Quotation (NASDAQ) market, which is the second largest securities market in the United States and one of the five largest in the world, and the over-the-counter securities markets. This task encompasses both regulation of NASD member firms and the individuals associated with those members.

The NASD has 5,982 broker-dealer members employing 429,000 registered sales persons and principals. Some 4,900 securities issued by 4,200 companies are quoted in the NASDAQ market and 439 NASD members serve as market makers in those securities. The scope of the NASD's regulatory jurisdiction extends to all such members and their associated persons.

The NASDAQ stock market is a highly visible screen-based market with intense competition between market makers. Their bid and offer quotations are continuously displayed over thousands of subscriber terminals, with real-time transaction reports for all NASDAQ/National Market System stocks. Ownership and participation by investors in the NASDAQ market is broad and diverse. Individual investors own approximately two-thirds of the market value of NASDAQ stocks. Institutional investors are also very active in NASDAQ -- and are becoming a growing part of our market -- but individual participation is paramount, thus the NASD is concerned with the perceptions of individual investors about today's markets. Investor protection is the cornerstone of the NASD's regulatory and enforcement efforts.

The Capital Markets Competition, Stability, and Fairness Act of 1990

The Administration's proposed legislation comprises three major provisions:

- Shift regulatory authority for stock index futures to the SEC in a manner that minimizes the disruption to the current operation of the markets in these instruments.

- Provide the SEC with oversight authority over the futures exchanges' ability to set margins, similar to its current oversight authority over margin setting by the securities and options exchanges.

- Modify the "exclusivity clause" of the Commodity Exchange Act to end pointless litigation and remove barriers to innovation that are driving new products to foreign markets.

Issues Confronting the Securities Markets

The market breaks of October 1987 and 1989 confirmed that the markets for stock and stock derivatives constitute, in economic terms, a single market. This interrelationship, documented in the Brady Commission report on the 1987 market break, has been accepted by the overwhelming majority of scholars, investors, regulators and others who have studied the issue. Logically it follows that these markets should be regulated in a consistent and coordinated manner that will minimize the likelihood of major market disruptions that negatively impact investor confidence and capital formation.

Markets are not attracting individual investors as they used to, partly because of the efficiency of investing through institutions, and partly from the uncertainties surrounding the markets. While the NASDAQ market has strong representation by individual investors, it is a matter of some concern to us that the percentage of publicly traded stocks outstanding held by individuals declined from 84% in 1965 to 55% in 1989.

This decline in individual investor confidence and participation is reflected in the decline in Initial Public Offerings (IPOs). After peaking at $18 billion in 1986, IPOs raised only $6 billion in each of 1988 and 1989, further reflecting investor unease after the 1987 market break, and slowing equity capital formation.

For the first time since the October 1987 market break, the NASDAQ market experienced in the second quarter of 1990 a slight upturning in individual investor interest in the markets and the amount of equity capital raised through IPOs. It would be a severe setback to the market and the economy if we were to experience another major market disruption because of an inability or failure to coordinate key intermarket mechanisms.

Stock Index Futures Jurisdiction

By way of preface, I do not believe this issue should be viewed as a "turf" battle between the Chicago commodities markets and the CFTC on one hand, and the New York securities markets and the SEC on the other, as some have suggested. The SEC regulates large securities and options markets located in Chicago, and the CFTC has oversight over several futures exchanges in New York, and no one suggests that either of them exhibits a bias due to location of the exchanges they regulate. Furthermore, if this legislation is adopted, there will be no shift of index futures contracts away from the markets in which they now trade. The proposed legislation is about something much more important -- restoring investor confidence in the nation's capital markets.

The NASD, both as one of the largest regulators of the securities markets, and as an operator of a market with a large share of individual investor participation, sees this provision as the key part of the Administration's proposal in helping to restore investor confidence in the markets. The current scheme of split regulation of stocks and stock index futures contracts leads directly and inevitably to hobbled intermarket enforcement, thereby impacting investor confidence in the markets for both products. The reason this split approach hobbles enforcement is simple: With two regulators each covering only their half of one market, there is no practical, comprehensive and continuing means to detect and thus prevent fraud in transactions between those two parts of the market.

Securities exchanges under SEC oversight have advanced automated systems that provide trade-by-trade information on a consolidated tape and audit trails with time of execution. The futures markets, on the other hand, do not have this information, which often impairs intermarket fraud investigations. Unifying jurisdiction over stocks, stock options and stock index futures in the SEC will significantly enhance the ability to promptly obtain and rationalize the information needed for intermarket investigations, and thus strengthen efforts to prevent fraud.

Bifurcated regulation under the SEC and CFTC makes it more difficult and time consuming for securities and futures exchanges to work out information sharing issues than working out those issues between stock and options exchanges, which are regulated by the SEC. For example, it took the New York Stock Exchange and the Chicago Mercantile Exchange some seven years after the S&P 500 futures contract was established to come up with initially acceptable front running prohibitions. On the other hand, securities and options exchanges, both of which are regulated by one regulator, the SEC, worked out such prohibitions a decade ago.

Separation of regulatory authority also impairs obtaining cooperative agreements with foreign regulatory authorities, since such agreements on behalf of the United States must be negotiated separately, or in stages, with both the SEC and the CFTC, which results in a process that is certainly more expensive and time consuming, and often less effective.

Transfer of jurisdiction would not weaken CFTC regulation over other commodities. Stock index futures are only 5% of all futures trading, and are the only one of the 20 largest futures contracts (as measured by contract volume) that is based on a stock index. Moving this responsibility to the SEC would allow the CFTC to concentrate its resources on the other financial and physical commodities futures, which account for the overwhelming percentage of activity in the markets it is charged with regulating.

Transfer of jurisdiction will also not be the "opening wedge" for the SEC to pick up all of futures regulation. Stock index futures, unlike the markets for physical commodities, have a significant underlying cash market, and represent a relatively large part of the derivative market as compared with the cash market. When coupled with the close interrelationship of these markets, these factors make stock index futures the core of the problem in the securities markets, and thus the only jurisdictional shift that the Administration's proposal contemplates.

The NASD recommends the transfer of jurisdiction over stock index futures to the SEC because it has the broadest expertise in regulating stock and stock derivative markets, has been charged by Congress since 1934 to assure that those markets not only operate in a fair and orderly manner but also importantly for the protection of investors, and has carried out that responsibility efficiently. Indeed, in our judgement, the investing public will be reassured to know that at all times, but particularly in times of market stress, there is one agency at the federal level charged with overseeing all aspects of the "single market" for stocks, stock options, and stock index futures.

Margin Regulation for Stock, Options, and Stock Index Futures

A key area of concern for the NASD and others interested in the stability of the securities market is the appropriate level of margins for stocks, stock options and stock index futures and the need for a coordinated approach to the establishment of such margins. This does not imply equality of margins but rather the need for consistency in the application of the standards used to determine appropriate margin levels whether they be for determining the amount of leverage that can be used to acquire control of financial assets or for prudential purposes to protect the financial integrity of market participants. While there is federal oversight of margins in the stocks and stock options markets, there is virtually none in the stock index futures markets. In the absence of such oversight, there is no way to harmonize margins between these instruments to protect the public's interest.

In terms of leverage, the fact is that futures professionals and institutions can control such a large amount of stocks with so little money that relatively small amounts of capital can potentially place significant selling pressure on the underlying stock market, with the result being a major market disruption.

For example, before the October 1989 break, a futures trader with $50,000 could control $2 million in stock, ten times more than the securities trader because of the widely differing margin requirements between markets. Even though margins were raised by the futures exchanges after the 1987 break, they were actually dropped by those exchanges to lower levels in October 1989 than they were before the 1987 break, and were at 2 to 3% on October 13 and 16, 1989. During these market breaks, when the need for liquidity is the greatest, futures exchanges drain liquidity through margin calls and increased rates, just the opposite of what should be occurring. As Alan Greenspan, Chairman of the Federal Reserve Board, testified before the House Subcommittee on Telecommunications and Finance on May 24:

> Although no futures clearing house has ever suffered a loss from a default on a stock index futures contract, certain actions by futures exchanges and their clearing houses in recent years raise questions about the adequacy of futures margins from a public policy perspective. Specifically, we have concerns about the tendency for these organizations to lower margins on stock index futures to such a degree in periods of price stability that they feel compelled to raise them during periods of extraordinary price volatility. While such a practice has heretofore protected the financial interests of the clearing houses and their members, it tends to compound already substantial liquidity pressures on their customers, on lenders to their customers, and on other payment and clearing systems. In the Board's view, somewhat higher margin levels on stock index futures would obviate the need to raise them in a crisis and thereby reduce concerns about the reliability of our market mechanisms, especially clearing and payment systems, in times of adversity.

The NASD shares the view of the Federal Reserve Board, the Department of Treasury, and the SEC that federal oversight is appropriate to ensure that margins on stocks, stock options and stock index futures are established at levels that are adequate under a wide range of market conditions. To achieve this needed consistency, we further believe that this oversight should be vested in the one federal agency that already has this authority for two of the three interrelated products involved -- the SEC.

Consolidating margin oversight responsibilities in the SEC will also facilitate cross margining, advocated by the Brady Commission, and the White House Working Group. Cross margining allows options and futures clearing houses to share position information for common clearing members and to calculate an overall margin requirement based on their combined positions. By avoiding over-collateralization of intermarket hedge positions at the clearing houses and thus for firms and market makers, it rationalizes credit requirements at prudential levels and sustains or increases market liquidity. Cross margining has the especially desirable result of decreasing the risk to the clearance and settlement systems in times of stress.

A more detailed analysis of the margin issue and the desirability of cross margining will be provided by Wayne Luthringshausen in his testimony on behalf of the Coalition.

Modification of the Exclusivity Clause of the Commodity Exchange Act

The NASD supports the provision of the Administration's proposal to modify the exclusivity clause to allow instruments with both futures and securities characteristics to trade on both the securities and futures exchanges, and sees it as crucial if we are not to abandon such useful hybrid products to our competitors overseas. Because it is the American and Philadelphia Stock Exchanges Index Participations (IPs) that joined the issue on the exclusivity clause of the Commodity Exchange Act, James Jones, Chairman of the American Stock Exchange, will treat this issue in detail in his testimony.

While fragmented regulation may spur innovation, it can also cause jurisdictional quarrels that can stifle innovation and competition. This is precisely the situation with the development of IPs, the ensuing litigation that denied the securities markets the right to trade the product under the securities laws, and its subsequent shift to foreign markets. In that case, the Seventh Circuit Court of Appeals determined that any financial instrument with any degree of "futurity" must be traded on a futures exchange under the exclusivity clause of the Commodity Exchange Act. Since all new securities products have some element of futurity, this opinion has far reaching consequences for the competitiveness of our nation's securities markets in today's global environment.

As a final comment on innovation in the financial markets, we often hear that the futures markets are more innovative than the securities markets. This is simply inaccurate. The SEC has approved new product proposals since the 1970's that have included such derivative products as options on stock indexes, Treasury bonds, bills and notes, Government National Mortgage Association instruments, debt indexes, and foreign currencies. Moreover, under the securities laws and the SEC's watchful eye to assure compliance with disclosure and anti-fraud standards, issuers and their investment bankers have come up with approximately 30 different new securities in the past ten years, with a total trading volume well in excess of hundreds of billions of dollars. The securities markets, their participants, and the SEC are not less innovative, and they should be freed from the strictures of the exclusivity clause to allow even more of the innovation needed to remain competitive both domestically and internationally.

Conclusion

The NASD supports the Administration's proposed Capital Markets Competition, Stability, and Fairness Act of 1990 because it is good public policy: it would promote the safety and soundness of the securities markets, which are one of our nation's strongest assets; it would solve problems that result from fragmented regulation; it would help promote stability in the equity markets; and it would be a positive step toward restoring confidence of investors in our securities markets.

After the market break of 1987, the reforms contained in this legislation were identified as necessary. Three years -- and several market events -- later, these reforms are still waiting, market instability is still present, and individual investors have yet to return to the markets in significant numbers. We urge the Congress to listen to the warnings the market has been giving us in those past three years, and to pass this critical legislation now.

Thank you for your attention, and I would be happy to answer any questions you may have.

STATEMENT OF JAMES R. JONES, CHAIRMAN, AMERICAN STOCK EXCHANGE, NEW YORK, NY

Mr. JONES. Thank you very much, Mr. Chairman. I want to commend you and the members of the committee for holding this hearing and I want to put on record that we do support the coalition statement which Mr. Luthringshausen will be making and we support the administration's package.

It seems, first of all, that common sense itself dictates that what is acknowledged to be a linked market, equities, options, and stock index futures, should have some consistent and unified regulation of that market. And so we support that.

With respect to margin regulation, I believe the aim of the administration's bill is on target. With the futures and equities markets as interactive as they are, the most sensible policy is to have margin levels overseen by the one agency responsible for regulating our equity markets.

Regarding exclusivity clause, as you know, the American Stock Exchange and other exchanges introduced new products that we called index participations that were designed primarily for the retail individual investor. That product, virtually before it could be put up, was shut down by a legal action. Then the 7th Circuit of Chicago shut it down permanently because it found that under the CEA, if a product had any element of futurity to it, then it had to be regulated and traded as a futures product.

Well, new products need jurisdictional certainty. Their development is expensive and time-consuming, even when jurisdiction is crystal clear.

Now new ideas will be subject to a smell test. Is there any whiff of futurity? If there is, then the idea, no matter how useful, will probably be dropped for fear of litigation.

And I can tell you that we have had new products that have been discussed since that court decision that have not been put up for trading because of he fear of litigation.

And in the world of increasingly global markets, this cannot be the competitive position that Congress wants for our securities markets.

It's not just a matter of wasted resources and lost opportunity. In being denied index participations, the markets have lost a possible way to reduce market volatility. And the small investor has been denied the opportunity to participate in market trends the way institutions and large professionals can.

In hearing Senator Eagleton and Senator Mack, I think I, too, bring some unique experiences to this particular discussion.

In 1973–74, during my first term as a Member of Congress, coming from the agricultural State of Oklahoma, I voted to establish the CFTC.

I can assure you at that time, in the mind of this Congressman, there was no inkling that we would have any products like stock index futures, index participations, et cetera.

I can assure you that the purpose was to establish a credible regulatory framework for agricultural commodities that already existed for securities through the SEC.

I can assure you that the exclusivity clause that was placed in there was not to give a monopoly to the futures markets and prevent any kind of competition. But it was to give this new regulatory agency the CFTC, the authority and the superiority over 50 State commissions in regulating agricultural commodities.

Now, I still have a home in Oklahoma. Senator Dixon characterized this jurisdiction question as a Main Street versus Wall Street issue. I have businesses on Main Street in Oklahoma and I'm currently spending my time in the Wall Street area of New York.

I have a unique experience also that Senator Mack's comments reminded me.

In October 1989, the board of governors of the American Stock Exchange voted that I would be the new CEO of the stock exchange. That occurred on Thursday. The next day the market dropped 190 points. It took a day to get accustomed to a Democrat, but I think they're getting accustomed to a Democrat on Wall Street.

Senator **SARBANES**. You and Senator Mack need to commiserate with one another. [Laughter.]

Mr. **JONES**. But the point is, even though I was not responsible for the exchange at that time, I was in the middle of that storm and saw the kinds of decisions that had to be made very quickly and had to be made as accurately and honestly as possible.

I saw the confusion that occurred. And it just seems to me very common sense that if the regulator of an exchange has one Federal regulator to which he has to report, that the decisions that have to be made in those times of stress will be made much better.

Subsequent to that, as I pointed out, I've seen innovative new products such as our index participations unable to be traded because of this monopoly situation that exists under the exclusivity clause of the CEA.

I've seen those products go offshore to Toronto and soon to London, where individual investors, American investors, will be able to trade them.

As far as farm group opposition is concerned, I think all of us in the Congress who have served before or who serve now know the sophistication and the ability politically of the Chicago futures markets to develop political support among the farm groups. They do it exactly as Senator Eagleton pointed out. They send out an all-points bulletin and say in some way, you have to fight this because it's going to hurt cattle, it's going to hurt various kinds of agricultural commodities.

The real disappointment for me today, that the farm groups and the Chicago futures markets who were scheduled to be here for this hearing and were scheduled to be here with us so that we could trade comments and have a debate in front of this committee, is that some of the statements that are being made perhaps could be shot down or shown to be true if we had been here face-to-face.

I would only suggest that when you schedule a hearing for these groups, perhaps you will want the other side represented that same day, because I think that is the best way to come to what is the proper public policy.

It's been said that individual investors have lost confidence. I think that's true. Part of that is because they don't believe anyone in Washington is looking out for the public interest.

I think that if the Congress fails to act in this particular respect, and if there is another market break, the responsibility for that, I think, would be very serious and the lack of investor confidence will be driven further into the ground.

So I urge the committee to act and I'd be happy to answer any questions.

[The complete prepared statement of James Jones follows:]

Testimony of James R. Jones
Chairman, American Stock Exchange, Inc.
Before the Senate Committee on Banking, Housing and Urban Affairs

July 11, 1990

My name is James R. Jones. I am Chairman of the American Stock Exchange.

I commend Senator Dodd, Senator Heinz and the Committee for conducting hearings on the question of federal jurisdiction over the securities and stock index futures markets as well as the Administration's legislative proposal - the Capital Markets Competition, Stability, and Fairness Act of 1990. The questions raised by the current jurisdictional debate are among the most pressing in the securities and futures industry today and this hearing hopefully will shed light on the needs that the Administration's bill addresses.

I also wish to express support for the initiatives of the Ad Hoc Coalition for Intermarket Coordination in which the American Stock Exchange is a participant, along with other securities self-regulatory organizations. The Exchange shares the jurisdictional concerns expressed today by Wayne Luthringshausen in his testimony on behalf of the Ad Hoc Coalition.

The increasingly heated debate over SEC/CFTC jurisdiction has brought into focus two principal concerns that warrant Congressional action. First, while no one appears to contest that the stock, options, and stock index futures markets comprise "one market", as the Brady Task Force concluded following the October 1987 crash, serious regulatory bifurcation and inconsistencies exist.

Second, our securities marketplaces have been seriously disadvantaged as a result of the expansive interpretation given by the U.S. Court of Appeals for the Seventh Circuit to the "exclusivity clause" of the Commodity Exchange Act in its 1989 decision relating to Index Participations. Because the Supreme Court recently has declined review, the Seventh Circuit's decision is now the law of the land. Under that decision there is a danger that any product with an element of futurity, and not just stock index futures, may well be subject to exclusive CFTC jurisdiction. At the very least, there will be uncertainty and a proliferation of litigation to test the outer bounds of the "exclusivity clause." As a result, the initiatives of our securities marketplaces to develop new retail and institutional products, and to trade and market them as securities, will continue to be stifled.

The Administration's proposal to address these issues recognizes what common sense dictates - that integrally linked market segments must be subject to regulation that is unified and consistent. The Administration's bill is comprehensive but, at the same time, avoids unnecessarily intrusive new regulation. By providing for SEC oversight over stock index futures, as well as amending the CEA's "exclusivity clause" to undo the effects of the Seventh Circuit's decision, the Administration's proposal will enhance the soundness of our linked equity and derivative markets. At the same time, the proposal would eliminate competitive barriers to development of innovative and useful securities products and, indeed, would encourage their development. I, therefore, strongly endorse the Administration's initiatives, which I believe are critical to maintaining the integrity and international competitiveness of our markets.

Stock Index Futures Jurisdiction

Unified regulation across linked markets is a necessary adjunct to reduced market risk for all market participants and to increased investor confidence. While the securities and futures markets each have taken a number of steps, both individually and in concert, to remedy the most serious systemic weaknesses that became all too apparent after the October 1987 crash, regulatory disparities between stock and stock index futures markets continue to thwart comprehensive measures to further reduce market risk. The Brady Task Force Report identified margin, coordinated clearance and settlement procedures, circuit breakers, and surveillance as areas that require unified responses. Moreover, a single regulator of linked markets is necessary to address future market crises and to implement preemptive measures to deal with market volatility. By providing consolidated regulation, the Administration's bill promotes the soundness of our markets as a whole.

Disparate margin requirements for stock index futures and equities also require unified regulation, specifically SEC oversight, as the Administration has proposed. Futures exchanges currently can increase speculative and hedge margin requirements abruptly during rapidly declining market conditions, which may contribute to market risk by impacting market liquidity and affecting payment systems. Likewise, margin requirements could be reduced, when markets are relatively stable, to levels far lower than those required for securities. Different margin levels may be appropriate in view of the different functions of futures and equity or options margin, but margin levels must be set to minimize risk to the market as a whole and permit better evaluation of credit risk. Margin levels must be coordinated because our markets are interactive; margins established in the futures, options, and equity markets inevitably impact each other. The setting of margin levels is much too important to the health of our financial markets to continue to be subject to the competitive instincts of individual futures exchanges. Therefore, coordinated margin regulation under the oversight of a single regulator, as the Administration's bill provides, will serve to reduce the level of risk resulting from precipitous increases or decreases in required margin levels under varying market conditions.

Adequate systems for cross-margining, which can provide critical market efficiencies, also would be facilitated by unified regulation. It is essential that clearing corporations and exchanges be able to accurately assess risk in relation to the overall exposure of clearing members in related markets. A cross-margining system under the oversight of one regulator will improve risk assessment and permit more efficient deployment of funds to meet changing market conditions. Similarly, to facilitate the timely assessment of the financial condition of member firms, a single regulator would promote the integration of securities clearing agencies and futures exchange clearance systems.

From a broader perspective, we also must keep in mind that we may not yet have experienced all possible challenges to the stability of our markets. The amazingly rapid development of international securities and futures markets and of new domestic and global trading mechanisms may impose new market risks that may be even more difficult to grapple with than those which our markets have already encountered. Securities and futures exchanges here and abroad are working towards innovative technologies for trading and disseminating market information, on a 24 hour basis. We cannot know fully what new risks these new systems will introduce. Again, providing a single regulator over linked market technologies, comparable to the unified regulatory scheme for securities and futures that exists in all other countries, is the most efficient and responsible course of action. The Administration's bill facilitates this important goal and, I believe, will improve the worldwide competitiveness of all of our domestic markets - securities and futures.

Moreover, unified regulation will not impede competitiveness and innovation in our markets. Some have suggested that a jurisdictional split fosters intermarket competition and that the CFTC has done more to foster innovation than has the SEC. This is not the case. The securities industry today is fiercely competitive, and competition in the development of new securities products and technology has been furthered by SEC initiatives and oversight, which has been responsive and pro-competitive. Competition between futures and securities markets will be no less intense if the SEC oversees stock index futures.

CEA "Exclusivity Clause"

The Administration's proposal also addresses the barriers to competition and innovation created by the CEA's "exclusivity clause." The Seventh Circuit has nullified the SEC's approval of an important new product - Index Participations - based on the court's expansive interpretation of the "exclusivity clause". Without new legislation, securities exchanges arguably will have to demonstrate that a product designed for trading in a securities marketplace, and intended for traditional retail and institutional securities investors, is not a futures contract, and, indeed, lacks any element of futurity. I believe this is an unreasonably onerous requirement, particularly since the Seventh Circuit has taken an extremely broad view of what constitutes futurity in regard to financial instruments. Indeed, a number of traditional securities could be argued to have some element of futurity under this court's rationale, and thus the decision may cast a cloud over which agency has jurisdiction in areas previously thought to be clearly within the domain of the SEC.

I applaud the Administration's initiative to undo the effects of the court's decision by permitting instruments such as Index Participations to be traded on securities exchanges under the SEC's oversight.

The principal effects of the Seventh Circuit's decision are two-fold. First, it is less likely that securities markets will pursue development of securities products that may not survive analysis under the Seventh Circuit's decision. The considerable resources that the American Stock Exchange and other exchanges have applied to developing, marketing, and commencing trading in Index Participations, and in subsequent litigation, has resulted in a new judicial gloss on the CEA, albeit that a useful new investment vehicle has been denied to U.S. investors. But foreign markets, unencumbered by bifurcated securities and futures regulation, are encouraged to develop and trade abroad instruments such as Index Participations or similar products. Thus, at a time of burgeoning global markets, domestic securities markets are saddled with a legal framework that operates to our competitive disadvantage.

Second, in being denied Index Participations, our markets have lost the benefits of a possible means of tempering market volatility by alleviating market pressure generated by program trading and index arbitrage. The SEC, in fact, determined that Index Participations have this potential. Indeed, Index Participations were developed following calls by the SEC and others, after the 1987 crash, for market basket-type products that could deflect the market impact of program trading and index arbitrage.

In addition, individual investors have been denied the opportunity to purchase stock index-based instruments with intra-day market liquidity and thereby to participate in market trends as institutions do.

I would emphasize that Index Participations were designed as securities for both retail and institutional securities customers, and it is impractical to suggest, as some have, that such products could be readily adapted to the regimen applicable to futures customers. In the eyes of the public, futures are associated with speculation and hedging, not long term investing. The futures market has a far more limited retail customer base than its securities counterpart. Securities and commodities account approvals are not fungible, nor is registration for futures commission merchants and securities account executives. Many institutions are precluded from trading commodity futures. Margin requirements and clearance/settlement procedures, of course, are different for securities and commodities; and whereas IPs were margined as equities, and were designed primarily as alternative investment vehicles, stock index futures serve mainly speculation and hedging functions. IPs were designed for the securities marketplace; the many different features of the commodities market and its customer base were not compatible, in our view, with a successful Index Participations product.

The securities markets require legal and jurisdictional certainty; anything less will deter new product development and innovation. If our markets are to maintain and improve their competitiveness, domestically and internationally, exchange initiatives to create new instruments should be permitted to succeed or fail based on their merits and their usefulness to market participants. By enacting the Administration's proposal amending the "exclusivity clause", Congress will remove a serious competitive impediment and foster development of constructive new products.

I would stress that it is important that the statutory framework make absolutely clear that a product approved for trading on a securities exchange or in the securities markets would indeed be a security, and not a futures contract, for all purposes under the law. This is essential if we are to avoid inviting further regulatory confusion and possible litigation under the securities laws, the CEA, the Internal Revenue Code, or any other statute in which securities or futures are referenced.

In closing, I would acknowledge, as we all know, that there is serious disagreement about the impact of stock index futures trading or of disparities between futures and securities margin on market volatility. Most recently, the CFTC and SEC have come to widely differing conclusions on the market effects of program trading in their studies of the October 1989 market break. These disagreements are rooted in the multiplicity of complex facts and trading patterns that must be analyzed before any plausible conclusions can be drawn. Whatever the cause, however, the problem remains a real one for investors, for member firms, and for market makers, each of whom bears unique risks as a result of volatile markets - particularly rapidly declining ones.

It does not help solve the problem to say that a link between stock index futures trading and volatility has not been proven. Our markets do not have the luxury of time to wait for "proof", if it ever comes. We need to put in place new mechanisms to enhance investor confidence and to assure that we can withstand and survive extreme and increasingly unpredictable market pressures. I believe the Administration's proposal, by consolidating regulation of our equities and derivative markets, aims to place all market segments in a much stronger position to withstand such pressures - now and in the future.

I appreciate this opportunity to share my views with the Committee.

Testimony of James R. Jones
Chairman, American Stock Exchange, Inc.
Before the Senate Committee on
Banking, Housing and Urban Affairs

July 11, 1990

The Administration's proposal to address issues arising from bifurcated regulation of stocks, options and index futures recognizes the common sense notion that integrally linked market segments should be subject to regulation that is unified and consistent. The Administration's bill is comprehensive but, at the same time, avoids unnecessarily intrusive new regulation. By providing for SEC oversight of stock index futures as well as amending the CEA's "exclusivity clause", the Administration's proposal will enhance the soundness of our linked equity and derivative markets. At the same time, the proposal would eliminate competitive barriers to development of innovative and useful securities products.

Disparate margin requirements for stock index futures and equities require unified regulation and oversight. Different margin levels may be appropriate in view of the different functions of futures and equity or options margin, but margin levels must be set to minimize risk to the market as a whole and permit better evaluation of credit risk. Unified regulation would also facilitate cross-margining and integration of futures and securities clearance systems. This will improve risk assessment and permit more efficient deployment of funds to meet changing market conditions.

By addressing barriers to competition and innovation created by the judicial interpretation of the CEA's "exclusivity clause", the Administration's proposal also removes jurisdictional uncertainty and encourages new product development. If Congress does not amend that provision, product innovation will be stifled or will move abroad, and the U.S. investor will be denied instruments such as Index Participations which may help reduce market volatility. Index Participations were designed for both retail and institutional customers; it would be impractical to market such a product as a futures contract, in view of the different characteristics of the futures market and its customer base. Our securities markets must be permitted to compete and innovate effectively, freely, and with jurisdictional certainty, and the Administration's bill accomplishes those aims.

Senator Dodd. Thank you very much, Jim. I appreciate your point on the hearing. In the past, I've conducted hearings, and I like the dynamic of a panel, in fact, where we can just sit back and get away from the formalities and allow the witnesses to engage in debate.

But the practicalities were such that that particular style was not going to work here today.

So I don't disagree with your point. That's the way I normally do these. But in this particular case, we had to do it a bit differently.

Senator Sarbanes. Mr. Chairman, could I just interject at that point, though, to say that I do want to commend you for originally structuring the hearing in that fashion. I think it's much to be desired. We would have had a chance for an exchange of competing points of view at the table, so you don't get this situation where you almost have like two ships passing in the night.

They pass in that direction, then later they come and they pass in that direction. There's no interaction and interexchange. And I regret very much that the other part of this panel which would have, in effect, constituted that dynamic, apparently chose or opted to appear on another occasion.

Senator Dodd. I thank my colleague.

Mr. Luthringshausen.

STATEMENT OF WAYNE LUTHRINGSHAUSEN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, OPTIONS CLEARING CORP., CHICAGO, IL

Mr. Luthringshausen. Mr. Chairman, my name is Wayne Luthringshausen. I am chairman of the board of the Options Clearing Corp., which is the common clearing and settlement agency for all exchange-traded, SEC-regulated options.

I am privileged to appear before the Banking Committee today on behalf of the Ad Hoc Coalition for Intermarket Coordination. In addition to the OCC, the members of the coalition are the American, Boston, Midwest, Pacific, and Philadelphia Stock Exchanges, the Chicago Board Options Exchange, the National Association of Securities Dealers, and the National Securities Clearing Corp.

I am pleased to appear with James Jones, chairman of the American Stock Exchange, and Mr. Hardiman, president of the National Association of Securities Dealers, two of the distinguished members of our coalition.

The coalition's unity of purpose is noteworthy. Its members represent broad segments of the securities industry and frequently are active and aggressive competitors. We have joined together because of our sense of urgency about the need to reform the system for regulating our financial markets.

It is a cold, sobering fact that Japan now rivals the United States as the world's financial center. The European community represents another aggressive challenge to United States financial leadership. Efficient capital formation is essential to a strong economy. Unfortunately, our irrational regulatory structure has dampened product innovation, reduced competitivenes, and jeopardized investor confidence.

The market breaks of October 1987 and 1989, clearly demonstrated what we have all known for some time—the markets for stocks and stock derivatives constitute a single market. There is a compelling need for increased coordination to lessen the risk of market disruption and to guarantee that investors and issuers can and will invest in efficient markets.

Our fragmented regulatory system has undermined the markets and jeopardized capital investment in three ways.

First, it has inhibited effective regulatory coordination. Investors and issuers must be assured that Federal regulators are in a position to respond swiftly and adequately during periods of market stress. The Brady Commission, the White House Working Group, and others have identified a number of mechanisms, including coordinated circuit-breakers and cross-margining to provide more effective intermarket coordination.

Proper implementation of these mechanisms is best and most directly furthered by a single Federal regulator.

Second, regulatory fragmentation has prevented the implementation of coordinated margin rules that assure the safety and liquidity of our markets. Some of the critics of the legislation have argued that margins on SEC-regulated stock index options are comparable to those required by futures exchanges for stock index futures. Therefore, SEC regulation is not needed.

These critics, however, are looking at only half the picture. While the clearinghouse margin payable to OCC on stock index options traded on CBOE is comparable to that required by futures clearinghouses, the customer margin payable to the broker dealer is significantly higher than that payable to the futures commission merchant. The higher customer margin on stock index options creates a cushion of liquidity to soften the impact of a market downturn, a cushion that does not exist in the futures markets.

SEC oversight of stock index futures margins would assure prudential margin levels in those markets and would remove the regulatory obstacles to cross-margining, an important market reform which would reduce credit and cashflow problems in our markets.

We concur fully with Chairman Greenspan and the Federal Reserve Board, however, that margins on stock index futures and other products should be set only at prudential levels.

Finally, bifurcated regulation has stifled the development of innovative products. The exclusivity clause of the Commodity Exchange Act creates a steel curtain between the securities and commodities markets.

Last year, for example, the 7th Circuit Court of Appeals, in deciding a lawsuit brought by two futures exchanges, blocked the introduction of an innovative new product designed to provide an additional layer of liquidity to the stock market, the Index Participation, or IP.

During the limited time when IP's were traded on the American and Philadelphia Stock Exchanges, hundreds of investors bought these products despite uncertainties created by the pending litigation.

Today, as a result of the court's interpretation of this exclusivity clause, IP's cannot be purchased in any U.S. markets. However, IP's-type products are currently traded on the Toronto stock exchange and plans are underway for trading in London.

Mr. Chairman, the members of the coalition strongly support the three major reforms set forth in the Capital Markets Competition, Stability, and Fairness Act of 1990. Swift passage of this legislation would constitute a major step forward in resolving the most critical regulatory problems facing our markets today.

Thank you very much.

[The complete prepared statement of Wayne Luthringshausen follows:]

WAYNE P. LUTHRINGSHAUSEN
CHAIRMAN OF THE BOARD
THE OPTIONS CLEARING CORPORATION

SUMMARY OF TESTIMONY BEFORE THE UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

July 11, 1990

WHO WE ARE

I am privileged to testify today on behalf of the Ad Hoc Coalition for Intermarket Coordination. The members of the Coalition are the American Stock Exchange, the Boston Stock Exchange, the Chicago Board Options Exchange, the Midwest Stock Exchange, the National Association of Securities Dealers, the National Securities Clearing Corporation, the Options Clearing Corporation, the Pacific Stock Exchange, and the Philadelphia Stock Exchange. These organizations, normally tenacious business competitors, have joined together because of their common belief in the importance of swiftly and properly addressing the problem of bifurcated regulation of the equity and equity-derivative markets.

THE PROBLEM

- Regulation of the markets for stocks, stock options and stock index futures currently is fragmented between the SEC and the CFTC. The market breaks of October 1987 and 1989 clearly demonstrated that these markets constitute, in economic reality, a single market. A single market requires a single federal regulator.
- Regulatory fragmentation has undermined the competitiveness of our markets and jeopardized capital formation and investment in three ways:

  1. By impeding the regulators' ability to provide effective intermarket coordination necessary to maintain investor and issuer confidence in our capital markets. Market participants need to be assured that adequate regulatory safeguards exist during times of market stress. The Presidential Task Force on Market Mechanisms, the White House Working Group and others have identified a number of mechanisms to provide more effective intermarket coordination and to reduce the

market dislocations created during periods of excessive volatility. Among these are coordinated circuit-breaker mechanisms, cross-margining authority, and coordinated clearing and settlement mechanisms. Proper implementation of these and other intermarket mechanisms is best and most directly furthered by a single federal regulator with authority over the full range of equity and derivative products.

2. By preventing the implementation of coordinated margin rules that ensure market liquidity and safety. Coordinated margin-setting authority in the SEC would allow investors to make rational investment decisions and, at the same time, guarantee sufficient liquidity in times of market stress. For example, margin-setting authority consolidated within the SEC would remove obstacles to cross-margining -- an important reform endorsed by The Presidential Task Force on Market Mechanisms, the White House Working Group and the SEC. Cross-margining allows clearinghouses to share position information and liens on common clearing members and, thereby, to calculate an overall margin based on combined positions. This reduces credit and cash-flow problems in the markets by permitting options market makers to take advantage of the risk reduction inherent in intermarket hedge positions.

3. By stifling the development of financial products that investors find useful and attractive. For example, the Index Participation ("IP"), designed by the American Stock Exchange, the Philadelphia Stock Exchange, the Chicago Board Options Exchange ("CBOE"), and the Options Clearing Corporation ("OCC"), was an innovative "market basket" product representing a broad range of securities. Because the Seventh Circuit found that the IP contained some elements of a futures contract, it was subject to the CFTC's exclusive jurisdiction and could not be traded on any U.S. securities exchange. Foreign exchanges are trading or preparing to trade IP-type products, however. The futures markets which sued to prevent IP trading were not trading the products then and are not trading them now.

Given the recent public debate over the Gorton-Wirth-Heinz Proposal, an additional word is needed on the subject of margin regulation. Some critics of the proposal have claimed that margins on SEC-regulated stock-index options are basically the same as the margins on stock-index futures -- therefore, SEC regulation of futures margins is unnecessary. These critics are looking at only half the picture, however. There is no question that margins on stock-index options are significantly higher than on stock-index futures.

While the clearinghouse margin payable to OCC on stock-index options traded on CBOE is comparable to that required by futures clearinghouses, the customer margin payable to the broker/dealer is significantly higher than that payable to the futures commission merchant trading on a futures exchange. For example, the customer margin required on the S&P 100 Index Option is currently set at approximately 15% of the index's value. The customer margin for the vast majority of futures customers buying the S&P 500 Index Future, on the other hand, is only approximately 4.5% of the index's value -- less than one-third of the margin required for SEC-regulated options.

The higher margin on stock-index options affords that market a cushion of liquidity to soften the impact of a market downturn. That cushion simply does not exist in the stock-index futures markets.

THE SOLUTION

The "Capital Markets Competition, Stability and Fairness Act of 1990" -- the Gorton-Wirth-Heinz Proposal -- would go a long way toward addressing the problems of bifurcated market regulation. The Ad Hoc Coalition for Intermarket Coordination therefore strongly endorses the three major reforms set forth in this legislation:

1. Transfer regulatory jurisdiction over stock-index futures to the SEC, permitting greater regulatory coordination over the stock and stock-derivative markets;

2. Move margin-setting authority over stock-index futures to the SEC, permitting the coordination of margin requirements at prudential levels for the full range of stock and stock-derivative products; and

3. Modify the exclusivity clause in Section 2(a) of the Commodity Exchange Act to allow trading of many sophisticated, hybrid financial instruments outside the futures exchanges.

STATEMENT
OF
WAYNE P. LUTHRINGSHAUSEN
CHAIRMAN OF THE BOARD
THE OPTIONS CLEARING CORPORATION

BEFORE THE
UNITED STATES SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

July 11, 1990

Mr. Chairman, my name is Wayne Luthringshausen. I am Chairman of the Board of The Options Clearing Corporation (the "OCC") which is the common clearing and settlement agency for all exchange-traded, Securities and Exchange Commission ("SEC") regulated securities options. Our subsidiary, The Intermarket Clearing Corporation (the "ICC"), serves as a clearing and settlement house for trades in futures contracts and commodity options on three commodities exchanges. As a result of our daily monitoring of trading activity, we have a clear and steady eye on the function and operation of the capital markets.

I am privileged to appear before the Committee today on behalf of the Ad Hoc Coalition for Intermarket Coordination. In addition to the OCC, the members of the Coalition are the American Stock Exchange, the Boston Stock Exchange, the Chicago Board Options Exchange, the Midwest Stock Exchange, the National Association of Securities Dealers, the National Securities Clearing Corporation, the Pacific Stock Exchange, and the Philadelphia Stock Exchange. These self-regulatory organizations -- located from coast to coast -- are active in virtually every aspect of America's securities industry.

The unity of purpose of the Coalition is noteworthy and remarkable. Its members represent broad segments of the securities industry and frequently are active and aggressive competitors. We have joined together because of our sense of urgency about the need to reform the system for regulating financial market instruments in order to remove obstacles to product innovation, to ensure the continued competitiveness of the United States capital markets, and to restore investor and issuer confidence in the integrity and stability of those markets.

It is a cold, sobering fact that for several years now Japan has rivaled the United States as the world's financial center. With the formation of the European Community, yet another aggressive challenge to U.S. financial leadership will emerge. The ability to raise capital efficiently is central to a strong and prosperous economy. Unfortunately, our Nation's capital markets are hamstrung by an irrational regulatory structure that, in many instances, has dampened product innovation and reduced competitiveness.

The market breaks of October 1987 and October 1989 clearly demonstrated what we have all known for some time: the markets for stocks and stock derivatives constitute, in economic terms, a single market. Because of the close linkages among the stock, stock option and stock-index futures markets, there is a compelling need for increased intermarket coordination to lessen the risk of market disruption and, even more importantly, to guarantee that investors and issuers have access to efficient, cost-effective markets.

Most important, we agree with the Bush Administration that increased intermarket coordination is essential for guaranteeing the confidence of American investors in the stability and integrity of the markets. Investors must be assured that federal regulators are in a position to respond swiftly and adequately during periods of market volatility. Without such assurances, the current trend of declining investor participation and capital formation likely will continue.

The fragmentation of our regulatory system has, in short, undermined the competitiveness of our markets and therefore jeopardized capital investment in three ways. First, it has rendered difficult the type of effective regulatory coordination that instills investor and issuer confidence. Second, it has prevented the implementation of coordinated margin rules that ensure efficient, sound investment decisions. Finally, the fragmentation has stifled the development of products that investors find useful and attractive.

The members of the Ad Hoc Coalition for Intermarket Coordination therefore strongly support the three major reforms set forth in the "Capital Markets Competition, Stability and Fairness Act of 1990": (1) the transfer of regulatory jurisdiction over stock-index futures to the SEC; (2) the consolidation of margin authority over stocks and stock derivatives under the SEC; and (3) modification of the exclusivity clause in Section 2(a) of the Commodity Exchange Act.

Effective Regulation: Unified Regulation of Stock, Stock Options and Stock-Index Futures

Although the stock, stock options and stock-index futures markets are now regulated by different government authorities and employ very different clearing structures, the economic reality is that these markets are closely joined by common underlying products and trading strategies that cross traditional market boundaries. In short, the markets for stock, stock options and stock-index futures comprise a single, unified marketplace in which trading in any of the markets necessarily affects the others.

Investors, investment banks and other significant market participants readily recognize the connection of these markets. However, our current regulatory system is disconnected from that reality. The fragmentation of regulatory responsibility over the equity and equity-derivative markets forces the regulators to view the unified marketplace as distinct markets -- which has impeded the regulatory programs of both the SEC and the CFTC.

Because this regulatory myopia is at odds with the economic realities of the marketplace, it hamstrings the regulators' ability to respond quickly and fully in times of market stress. The market breaks of 1987 and 1989 clearly revealed that one agency must have the authority to respond to critical intermarket issues and to monitor and regulate intermarket activities.

The creation of unified regulatory authority over the equity and equity-derivative markets is especially critical to guarantee the confidence of investors and issuers in the stability and integrity of our capital markets. Investors and other market participants need to be assured that adequate regulatory and other safeguards exist during times of market stress.

This Committee, the Brady Commission, the White House Working Group and others have identified a number of mechanisms to provide more effective intermarket coordination and to reduce the market dislocations created during periods of excessive volatility. Among these are coordinated circuit-breaker mechanisms, cross-margining authority, and coordinated clearing and settlement mechanisms. Proper implementation of these and other intermarket mechanisms is best and most directly furthered by a single federal regulator with authority over the full range of equity and derivative products.

By unifying the regulation of stocks, stock options and stock-index futures under the SEC, the Administration's proposal would permit effective intermarket coordination. This transfer of regulatory jurisdiction makes eminent sense not only because of the close linkages among the stock, stock option and stock-index future markets, but also because the SEC has the broadest expertise in regulating equity products. The transfer of regulatory authority over stock-index futures does not, in our view, reflect in any way upon the record or performance of the Commodity Futures Trading Commission ("CFTC"). It simply reflects the logical conclusion that a unified marketplace requires unified federal regulation. Moreover, the transfer to the SEC of jurisdiction over stock-index futures would not require a radical departure from the current regulatory framework -- stock-index futures comprise but a small percentage of the transactions regulated by the CFTC.

Efficient, Sound Investment Decisions: Unified Regulation of Margins

As a further recognition of the unified marketplace for equity and equity-derivative products, we believe that there are important benefits to be gained from the consolidation of margin authority for stocks, stock options and stock-index futures under a single regulator -- the SEC. Coordinated margins would help assure that investors can make rational investment decisions and at the same time help guarantee sufficient liquidity in times of market stress. Under the current fragmented regulatory regime, margins cannot be adequately coordinated among equity-based products even though investors treat such products as part of a single market.

The issue of margin regulation has emerged as a major point of contention in the public debate over the Administration's proposal. In particular, some of the critics have argued that the SEC-regulated margins on securities options traded on the CBOE and cleared by OCC are not materially different from the margins required by futures exchange clearinghouses for CFTC-regulated stock-index futures. Thus, the critics conclude that there is no case for SEC regulation of futures margins because the SEC has required basically the same margins for CBOE-traded options as the futures exchanges have required for stock-index futures. This observation, however, takes into account only half of the picture with respect to margins on securities options.

When we talk about margins on securities options, we have to look at margin requirements on two distinct levels: first, the clearinghouse margin that the broker/dealer must pay to OCC and, second, the customer margin that the option writer must pay to the broker/dealer. Dr. Gramm and others are quite correct in stating that the clearinghouse margin payable to OCC is comparable to that required by the futures clearinghouse. However, at the customer level, securities option writers are required to pay a substantially higher margin to the broker/dealer than the vast majority of futures customers are required to pay to the futures commission merchant. This higher customer margin affords the securities options markets a reservoir of liquidity to draw upon in case of a market downturn. That reservoir does not exist in the stock-index futures markets.

For example, let us compare the margin requirements for the CBOE-traded S&P 100 Stock-Index Option and those for the Merc-traded S&P 500 Stock-Index Futures Contract. At the clearinghouse level, the securities broker/dealer currently is required to post a margin with OCC providing protection for an approximate 4.5% adverse movement in the value of the S&P 100 Index. Similarly, on the Merc, the futures commission merchant is required to pay the clearinghouse a margin protecting against the same approximate 4.5% adverse movement in the value of the S&P 500 Index. The comparison does not end here, however. So far, we are looking only at the clearinghouse margin requirement.

At the customer level, the broker/dealer executing an S&P 100 Index Option on the CBOE must collect from the option writer a margin equal to approximately 15% of the index's value. The futures commission merchant, on the other hand, when executing an S&P 500 Index Future on the Merc, collects a margin amounting to only approximately 4.5% of the index's value*/ -- less than one-third of the margin required on the SEC-regulated CBOE.

The securities broker/dealer retains that portion of the option writer's margin payment equal to 11.5% of the index value and passes along the remaining 4.5% to OCC. Thus, the broker/dealer retains a substantial cushion to guard against the risk of a downward price movement in the S&P 100 Index. Should such a movement occur, the broker/dealer has this cushion available to meet any additional margin calls imposed by OCC.

The futures commission merchant, however, obviously must pass along to the futures clearinghouse the entire 4.5% margin he collects from the futures customer -- leaving him with no cushion whatsoever to soften the impact of a downward price movement in the S&P 500 Index or a dramatic increase in margin protection in times of stress. In the event of such a movement, the futures commission merchant is obligated to pay any additional margin required by the clearinghouse, whether or not he is able to collect the money from the futures customer. This predicament obviously creates cash flow strains on the futures system in times of extreme volatility and market stress -- draining liquidity from the markets when it is most needed.

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*The approximately 4.5% margin is required of nearly 95% of futures customers. A much smaller number of other futures markets participants, known as "speculators", are required to post margin in the amount of approximately 12% of the value of the underlying index.

Let there be no mistake about it. There is no question that the margins required on SEC-regulated securities options are substantially higher than those required on CFTC-regulated stock-index futures. That is true today and it was true prior to the market breaks of October 1987 and October 1989. There also is no question that the higher leverage that exists in the futures markets poses a significant risk to market liquidity during times of market stress.

Three out of four members of the White House Working Group are in agreement on this point, including Federal Reserve Chairman Greenspan. In testimony before the House Telecommunications and Finance Subcommittee on May 24, Chairman Greenspan stated that:

> [a]lthough no futures clearinghouse has ever suffered a loss from a default on a stock index futures contract, certain actions by futures exchanges and their clearinghouses in recent years raise questions about the adequacy of futures margins from a public policy perspective. Specifically, we have concerns about the tendency for these organizations to lower margins on stock index futures to such a degree in periods of price stability that they feel compelled to raise them during periods of extraordinary

> price volatility...[This practice] tends to compound already substantial liquidity pressures on their customers, on lenders to their customers, and on other payment and clearing systems. (emphasis added)

Consolidating margin authority for stock, stock options and stock-index futures under the SEC will permit coordinated federal oversight of margins on these related products, thereby assuring that prudential margin levels will be maintained across the markets for equities and equity-derivatives. Consolidated margin authority offers other important benefits as well.

For example, margin-setting authority consolidated within the SEC would remove the regulatory obstacles to "cross-margining" -- an important market reform endorsed by the Brady Commission, the White House Working Group and the SEC as a needed and workable method of reducing credit and cash-flow problems in our markets. Cross-margining is designed to avoid any over-collateralization of the risk of intermarket hedge positions at the clearing house level and, consequently, for firms and their marketmakers and specialists. Cross-margining rationalizes credit requirements at prudential levels and operates to sustain or increase market liquidity, especially during times of stress. It takes the form of options and futures clearing houses sharing position information and liens for common clearing members and calculating an overall margin requirement based on the combined positions.

The OCC and its subsidiary, the ICC, initiated a pilot program which provides cross-margining of OCC-cleared securities options with futures positions cleared by ICC. Currently, the OCC and the Chicago Mercantile Exchange are operating a substantial cross-margin pilot. As a result, during the October 1989 market break, two substantial clearing members were able to reduce their margin payment obligations by approximately $150 million, evidencing the effectiveness of cross-margining in reducing unnecessary demand for liquidity during times of market stress while not increasing risk to the system.

This successful cross-margining program has not been expanded beyond the proprietary accounts of the two firms due, in large part, to regulatory impediments. In particular, while many options marketmakers are extremely active in the stock-index futures market for hedging purposes, cross-margining has not been extended to marketmaker accounts. The transfer of margin authority to the SEC for stock-index futures would remove the regulatory impediments and permit options marketmakers to take advantage of the risk reduction inherent in intermarket hedge positions.

Margins control the level of capital necessary for investment; cross-margining not only enables capital levels to be prudential across markets but encourages intermarket trading strategies that facilitate rational price movements. It is for these reasons that unified margin regulation in general and cross-margining in particular are essential to efficient, sound market decisions. We believe that implementation of cross-margining must be the first change made upon the transfer of margin-setting authority to the SEC.

We also believe it is important to emphasize that in setting coordinated margin requirements for stock-index futures and other equity-related products, the overriding concern should be to assure that margins are adequate to protect clearing organizations, brokers and other lenders from credit losses caused by price changes. We concur fully with Chairman Greenspan and the Federal Reserve Board that "the critical question is whether margins on stock-index futures have been maintained at levels that are adequate for prudential purposes."

Raising margins on stock-index futures to higher than prudential levels would not, for clearinghouse purposes, contribute to the safekeeping of our financial system. To the contrary, excessive margins serve only to threaten the liquidity of our markets and to make our foreign competitors more attractive to investors.

Product Innovation: Amendment of the Exclusivity Clause

The exclusivity clause in Section 2(a) of the Commodity Exchange Act, which vests the CFTC with exclusive jurisdiction over trading in futures contracts, creates a steel curtain between the securities and commodities markets. This rigorous, enforced separation has created jurisdictional controversy and confusion in our markets since 1974 -- particularly with respect to sophisticated, hybrid financial products which do not fit neatly into either the "security" or "future" category. As a result, the exclusivity provision poses a substantial barrier to financial product innovation and to the continued international competitiveness of the American capital markets.

The federal courts have interpreted Section 2(a) of the Commodity Exchange Act to mean that the CFTC has exclusive jurisdiction over instruments that are securities within the meaning of the 1933 and 1934 Securities Acts -- if such instruments have any attribute whatsoever of a futures contract. This holding by the courts has a far-reaching effect on our capital markets. As Federal Reserve Chairman Greenspan has testified, "[i]n a very general sense, all financial instruments have an element of futurity in them, in that their value depends on future events."

A recent judicial interpretation of the exclusivity clause confirms that the piecemeal approach of the Shad-Johnson Accord in 1982 serves only to create serious regulatory dysfunctions which ultimately deprive financial markets of new and highly desirable products. Last year, the Seventh Circuit Court of Appeals, in deciding a lawsuit brought by two futures exchanges and in which the CFTC joined as amicus curiae, blocked the introduction of a new financial product -- the Index Participation or "IP".

The IP -- a "market basket" product representing a broad range of securities -- was designed by the American Stock Exchange, the Philadelphia Stock Exchange, the Chicago Board Options Exchange and the OCC to fill a critical gap, exposed by the October 1987 market break, in the range of available investment instruments. In particular, IPs were designed to provide an additional layer of liquidity to the stock market, thereby enhancing the market's strength and stability. Unfortunately, the Seventh Circuit found that the IP contained some elements of a futures contract and was therefore subject to the CFTC's exclusive jurisdiction. Accordingly, IPs products cannot be traded on any securities exchange.

As the IPs case demonstrates, jurisdictional prerequisites, rather than market forces, now control the development of new financial instruments. The needs and demands of the investing public are secondary to the jurisdictional constraints imposed by the exclusivity clause. During the limited time when IPs were traded on the American Stock Exchange and the Philadelphia Stock Exchange, hundreds of investors bought these products despite uncertainties created by the pending litigation and despite the fact that a number of securities firms declined to market IPs products prior to the resolution of that litigation. Today, as a result of the court's interpretation of the exclusivity clause in the Commodity Exchange Act, IPs cannot be purchased in any U.S. market.

The IPs decision was a boon to our foreign competitors, however, because it allowed them to have the market for IPs-type products to themselves. Today IPs-type products enjoy active trading on the Toronto Stock Exchange, and plans are underway for trading in London. It should be noted that the commodity exchanges which fought to prevent the American Stock Exchange, the Philadelphia Stock Exchange and the Chicago Board Options Exchange from trading IPs were not trading the products then, nor are they trading them today. Nor has any futures exchange announced any intention or interest in making IPs products available to the investing public.

As a result of the stifling effect of the exclusivity provision, U.S. capital markets ultimately may be incapable of meeting the rising demand for newly-developed stock derivative products. There is no adequate solution to this dilemma short of repeal or substantial amendment of the exclusivity clause. It is no answer -- as the CFTC has suggested -- that the remedy lies in cross-registration of securities account executives and futures associated persons.

The reasons for this are simple. IPs were designed to be marketed as investments for retail securities customers and to be traded like securities -- not like futures contracts. Most retail securities customers have never maintained a futures account. Those customers are accustomed to the protections of the securities laws -- mandatory disclosure, SIPC insurance, and the like -- and they are not accustomed to futures-style margins and the resultant daily cash payments that are required. Further, IPs were designed to be traded like securities. Both the American Stock Exchange and the Philadelphia Stock Exchange made a specialist responsible for maintaining continuous and orderly markets in IPs, but, as I understand it, the CFTC would not allow a specialist to maintain a futures market in IPs.

Moreover, the market-making capability of participants in an IPs securities market was enhanced by their ability to cross-margin their hedging positions in options and other securities; on the other hand, cross-margining between options and futures is still not a reality for marketmakers. Market-making ability in the securities markets is enhanced further by the fact that securities broker-dealers can accommodate orders of size through block trades, which cannot be done on futures markets. Finally, the IPs traded on the American Stock Exchange provided for the delivery of the underlying common stocks at the option of the holder, and this would have been illegal if IPs had traded as futures contracts.

It is thus unlikely that IPs could be successful as a futures product traded under the jurisdiction of the CFTC. It is not surprising that no securities exchange or commodity exchange has sought to make them available as a future. Instead, as recent events have proven, customers who wish to invest and trade in IPs-type products will need to turn to foreign securities exchanges.

Indeed, the IPs experience exposes the fallacy of the CFTC's oft-stated argument that divided regulatory jurisdiction enhances competitiveness and innovation. To the contrary, the CFTC's exclusive jurisdiction -- which is part and parcel of our current bifurcated regulatory system -- operates in many instances to stifle product innovation, particularly where the innovation threatens the vested interests of the futures industry. This phenomenon promises to repeat itself again and again unless the exclusivity provision is repealed or modified.

Conclusion

The simple fact is that unless Congress acts to rationalize regulatory jurisdiction, the dysfunctions in the U.S. capital markets, and the consequent shift to foreign markets, will continue. Enactment of the Administration's proposal would constitute a major step forward in resolving the most critical regulatory problems facing our markets. The transfer of stock-index futures to the SEC, the consolidation of margin-setting authority under the SEC, and the elimination of the exclusivity clause would facilitate effective and necessary intermarket coordination with respect to equity-related products. The reforms would eliminate many of the competitive obstacles that now hinder America's capital markets and, most important, would help guarantee continued investor and issuer confidence.

Mr. Chairman, the swift passage of the Administration's regulatory proposal is necessary. The commitment of the diverse members of the Coalition to work together in spite of competitive differences underscores the urgency with which we view this problem. Our competitors throughout the world are moving swiftly and aggressively to build efficient and investor-responsive capital markets. We cannot allow arbitrary and artificial regulatory divisions to hamstring our ability to meet these competitive challenges.

Thank you very much.

Senator DODD. Thank you very much, and I thank all three of you.

I would announce that at the conclusion of this panel, the committee will take a break until 1:30 this afternoon. We have a series of votes occurring after 12:30, and so it would be difficult for us to come right back. So it will give people a chance to get some lunch and then we'll complete the hearing with the last panel this afternoon.

Let me just ask some quick questions here, if I can, and since there are just three of you here, I'll ask all three of you, except I have a particular question to you, Mr. Hardiman, relating to your testimony. But other than that, I would like to get all three of you to comment on these points.

There was an article in this morning's Times which, I don't know if you had an opportunity to read or not, the headline of which said, "Who Should Set Margin Levels?"

And I would ask unanimous consent, without objection, that that article be included in the record.

[The following article was subsequently submitted for the record:]

July 11, 1990 - NEW YORK TIMES

Market Place

Who Should Set Margin Levels?

By FLOYD NORRIS

With the financial futures industry fearing for its future, and some parts of the securities industry warning of a financial crisis unless there is reform, pressure is building for Congress to control just how much risk speculators can take when they use the futures market to bet on whether stock prices will rise or fall.

A major issue in the debate over the Bush Administration's proposal for changes in regulation of financial markets, on which the Senate Banking Committee will resume hearings today, is whether the Government should set limits on margins — the amount of money an investor must put up to take a position in the market.

"Any financial regulatory system has to be designed so that the ship is strong enough to remain afloat in a storm, not just on a bright sunny day," said Richard C. Breeden, the chairman of the Securities and Exchange Commission. "The current margin system for futures doesn't pass that test with the level of certainty and assurance that we would like."

Threat to Liquidity?

Those opposed to changes in margin requirements assert that they may destroy the financial futures markets by robbing them of the liquidity needed to operate and may drive business to overseas markets.

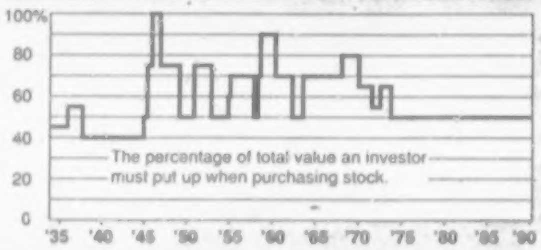
"Put a tax on us by raising margins, and see how long it takes to lose another industry to foreign countries," said William J. Brodsky, the president and chief executive of the Chicago Mercantile Exchange.

The debate in some ways recalls

Continued on Page D8

At Issue in the Regulation Debate

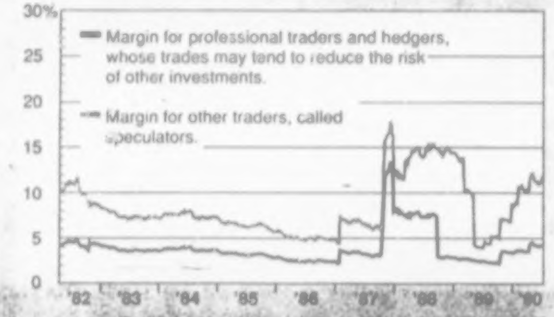
STOCK MARGINS HAVE LEVELED OFF AT 50 PERCENT



The percentage of total value an investor must put up when purchasing stock.

MARGINS ON FUTURES ARE LOWER AND MORE VOLATILE

The percentage of total value traders must deposit when buying or selling futures contracts on the Standard & Poor's 500 Index.



Source: Chicago Mercantile Exchange; Datastream; Federal Reserve Board

The New York Times

THE NEW YORK TIMES, WEDNESDAY, JULY 11, 1990

Market Place

Regulation Of Margins Is at Issue

Continued From First Business Page

the debates that followed the crash of 1929, which led to Federal regulation of stock market margins. Beginning in 1934, they were set by the Federal Reserve and now stand at 50 percent, although professional traders can effectively cut that in half. Investors in stock index futures, however, although they effectively own stocks, put up far less, as little as 3 percent of the value of the underlying stocks.

The bill backed by the Treasury Department would transfer authority over the stock index futures market to the S.E.C. The proposal is bitterly opposed by the futures markets and by the Commodities Futures Trading Commission, which now regulates the markets but can rule on margins only in emergencies.

As the hearings begin, some in the securities industry who favor the bill think they face an uphill struggle. "The President needs to really push this bill if it is going to pass," said one executive, who asked not to be identified.

Exchanges now set margins in the futures markets, and they have varied sharply. In 1987 and 1989, the margins required for some buyers of stock index contracts at the Chicago Mercantile Exchange fell to as low as 2.2 percent, while margins at the New York Financial Exchange dipped below 2 percent.

Stock index futures contracts are based on the value of the stocks in an underlying index, with the Standard & Poor's 500, traded at the Chicago Merc, being the most popular. The contract can trade for more or less than the value of the stocks until a certain date, when it expires and is guaranteed to be worth the same as the underlying index. In general, a buyer of such a contract will profit if stock prices rise while he holds it. The seller will profit if prices fall.

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Although both stock and futures markets use the term margin, the concepts are different. When an investor buys stock, the entire amount is paid to the seller, although the buyer may borrow up to half the amount from a brokerage firm as a margin loan. In a futures contract, the margin is simply a guarantee that the investor will be able to make good on any losses that may occur. Both buyer and seller in the futures market put up margins, but these margins need not be in cash. Often, Treasury bills are used.

The futures exchanges say they have adjusted margins in line with volatility, a move that Mr. Breeden, among others, said threatened to bring down financial markets in both 1987 and 1989. Although margins were low before the falls, they were raised sharply directly afterward, forcing traders to come up with an additional $900 million almost immediately in 1989.

"In the midst of a crisis, the futures markets were raising margins, draining credit from a market that was already under enormous stress," Mr. Breeden said. "So you can have a small fall in the market turned into a gigantic crisis because of the excessive leverage that people were allowed to incur," he said in an interview.

Mr. Breeden said it would make more sense to have higher margins in calm times — perhaps 12 percent to 15 percent — with the ability to lower them if needed in a crisis. It is clearly not necessary to raise them as high as stocks, he said.

■

There are actually two margin levels for stock index futures traders. The higher one is for self-described speculators, and the lower is for professional traders on the exchange floors and for traders hedging positions in other markets. For example, an institution that owned stocks and wanted to reduce its market risk by selling an index future would be considered a hedger.

In practice, critics say, many traders who qualify for the lower margins are speculators. "Have you ever looked at who gets a hedging margin?" Mr. Breeden asked. "It's who asks for it. Effectively, you self-certify your eligibility."

Just how much speculation takes place via stock index futures is a subject of much discussion. The futures industry generally plays down the amount, and some critics suggest it may be substantial. For an investor who wants to bet on rising, or falling, stock prices, futures clearly offer the chance for much quicker profits than stocks, albeit at a higher risk.

With more U.S. control proposed, exchanges fear a loss of business.

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Were margins for professionals to be raised sharply, futures officials say, there would be less trading because some traders would be priced out of the market. That, they say, would reduce liquidity and increase volatility. Some stock traders argue the reverse, contending that futures traders' ability to trade on low margins now increases current volatility.

"The main point is that people with very little cash are having a disproportionate affect on the equity market," said Richard Cantor, president of Neuberger & Berman, a New York money management firm that has campaigned for higher futures margins. "We think it is established, as a matter of national policy, that people without cash ought not to be able to speculate in the equity markets. That is what has gone amiss."

Futures industry officials contend there is no need to change the system. "The margin policies that the futures exchanges have pursued have really worked," said Steven Manaster, the chief economist of the C.F.T.C. "There have not been any defaults."

Many strategies who use stock index futures can also use stock index options, which are similar in many ways. Options margins are regulated by the S.E.C., and some in the futures industry have seized on that fact to argue that the S.E.C.'s failure to raise them shows that it knows no increase is needed, and is using the issue to gain authority over stock index futures.

Mr. Breeden said he believed option margins should be raised, but that it would be pointless without a similar rise in the futures markets. "It wouldn't reduce leverage in the markets; it would just transfer that leverage to the futures markets," he said.

A possible problem in the system now is that each futures exchange sets its own margins, and they have sometimes seemed to compete by lowering margins to attract business. More Government oversight could end that competition.

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At the moment, futures margins are relatively high. To buy or sell a single S.&P. 500 futures contract, representing about $170,000 in stock values, a speculator must put up $21,000, an amount that was raised by $1,000 late last month. Last summer, the figure was as low as $5,400. The requirements for hedgers and professional traders have risen over that period to $7,500, from $4,000.

Just why the margins have risen so far is a matter of dispute. Mr. Breeden has noted that they also rose in 1988, when the Reagan Administration was considering whether to take action, and began falling after it decided not to do so. He questioned whether a new fall would soon begin, if the current bill is defeated.

Todd Petzel, the chief economist of the Chicago Mercantile Exchange, said much of this year's increase was brought on by concern over volatility in Japan, where share prices fell sharply early this year, and not by politics.

Senator DODD. Mr. Brodsky, who is president of the Chicago Merc, comments, and I quote him. He says, "Put a tax on us by raising margins and see how long it takes to lose another industry to foreign countries."

I raised that point earlier this morning. This has been an issue that has been raised by folks from Chicago, that what you are all suggesting here by supporting this legislation, what the administration is going to end up achieving is just driving this industry right out of this country, and we're going to tend up losing once again a major part of financial services to foreign competitors.

LOSS OF FINANCIAL SERVICES TO FOREIGN COMPETITORS

That's the gist of what he's suggesting, and I wonder if all three of you, you commented a little bit on this, but I'd ask each of you to comment.

Mr. LUTHRINGSHAUSEN. Senator, I don't agree with Mr. Brodsky's comments or his position in that statement.

Senator DODD. You just raised the point about IP's, though.

Mr. LUTHRINGSHAUSEN. I'm sorry?

Senator DODD. You just raised the point about IP's and how Toronto was offering that product and apparently London is going to be offering it.

Mr. JONES. Mr. Chairman, on that score, the margins have nothing to do with that. The IP's were traded as a security. They had a 50-percent margin and they were a very popular product.

And they will be a very popular product here if the exclusivity clause is changed and we're able to bring it back to the United States.

The margin question, I think you might divide it two ways. One would be, who should be responsible for margins? I think the Chicago exchanges are very concerned because they're totally responsible for margins right now.

Senator DODD. But not totally. In emergency requirements, the CFTC does step in.

Mr. JONES. But they can set the margins now. They did increase the margins after the market break to, I believe, 15, 16 percent at one point, and there was no evidence that anything went overseas that was traded on those exchanges.

But I would separate margin question for commodities from the margin question for what is acknowledged to be a linked market of equities and those products derived from equities.

There, margins do relate, one linked market to the other. And there should be one regulator. I think from the public investor's point of view, they're wanting the Government, they're wanting a cop that belongs to the public to protect the public interest and now any particular exchange.

Senator DODD. Mr. Luthringshausen?

Mr. LUTHRINGSHAUSEN. I don't share Mr. Brodsky's——

Senator DODD. I cut you off and I didn't mean to. I apologize.

Mr. LUTHRINGSHAUSEN. The point that I was going to get into was the one that Mr. Jones made, which is the one about raising the margins to I think in the 16 percent area right after the markets events in October 1987, and it certainly didn't chase anything away.

I would make one additional comment about this whole margin issue. We tend to keep talking about the margin issue as one rate and volatility and the whole impact of margins and what have you.

In reality, what I believe is being suggested here, and the Chairman of the SEC and others would have to speak for what they mean and what they believe, but what I believe is being discussed here is the fact that there is no cushion in the future system as there is a cushion in the other systems, that 95 percent of the order flow to their markets are commercial hedgers. Only 5 percent are speculative accounts.

That the bulk of their business that's being done is being done as commercial hedgers; that the margin the FCM is requiring of the customer is identical to the margin that the clearinghouse is requiring of the FCM.

It's a mere pass-through of the margin requirements.

In our system, there's always a cushion where the customer using the market creating the strategy, the real user of whatever leverage exists, is that customer with the strategy, that that customer provides a cushion so that in times of some stress, you have a cushion in the market as clearinghouse margins do rise, that the broker doesn't finance it. He's got the money from the customer while he gets additional funds from the customer.

The reality is that that's the only part of this that I really think is at stake here. I think the issue is getting the commercial hedger margin, the margin the FCM requires of customers, at a rate that will produce a sufficient cushion so that times of stress don't create liquidity problems through the issuance of clearinghouse margin calls.

Senator DODD. Thank you. Mr. Hardiman.

Mr. HARDIMAN. Senator, there is absolutely no evidence, as Mr. Jones has pointed out, that the result would be the loss of the futures markets overseas.

We do have experience with much higher margin rates than exist today in the futures markets that came on in late 1987 and early 1988. And we did not lose any of those markets or any of that trading to overseas markets.

Second, I think that we also have to take a look at the bigger issue, and that is the risk to the entire financial system. And I think this is what Secretary Brady is driving at.

I think you need to have someone at the Federal level who is monitoring that risk. Even under this proposal, the markets would be allowed to set the margins themselves, but there would be someone at the Federal level who would have oversight who would be taking a look at this issue of what is the risk to the entire financial system. And when margins start to drift too low because of competitive reasons or for cost reasons to attract volume, there could be somebody who has a broader picture than just what is in the best interest of a single market.

And then take a look and impose those judgments in order to minimize the risk to the entire financial system.

Senator DODD. You made a point relating to my next question, which will give all of you a chance to respond to this as well.

You've heard today a number of suggestions kicking around here. A lot frankly have to do with the question of what we can do politically because of the problems that we face here, putting aside the question of whether or not it makes sense to do this.

I happen to subscribe to the notion that we need to do something here for the very point—your last point. You just can't leave this situation out there. The question of who does it or whether you do it incrementally, whether you do it as has been suggested by the administration.

So the first question I'd have for you, I'll make it just two or three questions together here and then turn to Senator Sarbanes—one is, what is the SEC going to do any differently than the CFTC is doing?

It's neat and tidy to talk about one agency, and two cops, three cops, four cops. I understand that there's a certain wisdom in that, but I think you've got to go beyond the question of just making it neat and tidy. I think we've got to explain what it is that is going to happen differently, whether you have one cop or three cops.

If you don't do something differently here with regard to margins, it seems to me you get to the very question that you raised, Mr. Hardiman, in your last point.

Second, does it make any sense in your minds, the three of you, to consider options such as mandating by legislation coordinated activities between the two agencies, if that's the only thing you can do?

Or two, as I raised with Tom Eagleton, the idea of having the Fed assume the responsibility, as is the case with stocks and then allowing them to defer, or rather, to designate responsibility.

Let me stop there, but those three points. And maybe there's a third or fourth option that we haven't considered here that you may want to raise, other than what the administration is proposing.

THREE POSSIBLE OPTIONS

Mr. HARDIMAN. I will take the first crack at the three questions.

What is the SEC going to do differently? Well, first, I think in the margins area, what they would do is to take a look at the issue that Mr. Luthringshausen raises, and that's the difference that you have in the amount of leverage that not the market participants have, but the customers can have, and try to draw some consistency into that amount of leverage that exists in the margin differentials now between the markets.

So I think that that is an approach that we would get as a consistent approach that cuts across all markets.

Second, the SEC has assured us, and we think this is a very important issue, that they would move quickly to expand the concept of cross-margining between the various markets in order to provide greater liquidity and in order also to provide a better identification of risk to the clearing systems.

A technical but very important issue, there have been significant efforts made, to try to get cross-margining in place during the past 2 years. And only now do we have a small pilot which Mr. Lutheringshausen can elaborate on, between his OCC and the Chicago Mercantile Exchanges clearinghouse.

As far as other alternatives are concerned, clearly, we think that the agency that has the best oversight of the securities markets is the SEC. And both from an enforcement point of view and from a risk point of view, that should be the appropriate agency.

If in terms of political compromise, if you will, it's necessary to consider alternatives, I think the only alternative we would find—speaking for the NASD—acceptable would be for the Fed to take on that responsibility and to be the oversight agency.

Now I think the idea of mandating coordination is going to be very difficult to achieve simply because of some very significant philosophical differences in the way both of those agencies approach the margin issue and also approach the enforcement issues.

Senator DODD. Thank you very much. Jim.

Mr. JONES. Well, I would agree with what Mr. Hardiman says. Speaking as a regulator, I would prefer to have one regulator to report to and coordinate, to have some sort of consistent regulation.

In terms of margins, I don't have any great concern about giving the Fed the total margin oversight responsibility, if that is the only thing that's possible.

As far as mandating coordinating activities, I think with just the way it's developed up to this point, you can mandate a lot of things, but in practice, it won't work.

So as far as what the SEC would do differently, A, again, there's no question that it's a linked market. B, they have almost 60 years of experience in regulating a securities-type market. And I think there would be more consistency aimed at securities markets if the SEC had full jurisdiction.

Senator DODD. Mr. Luthringshausen.

Mr. LUTHRINGSHAUSEN. Senator, am I clear that your question is just with respect to the issue of margins?

Senator DODD. Yes.

Mr. LUTHRINGSHAUSEN. Well, I don't want to speak just to speak. Most of the issues I think were——

Senator DODD. I'm identifying that as really where the rubber hits the road on this question. The other matters are, it seems to me, is not—they're important questions, but the one that's generating the greatest deal of interest is this one.

If that's not correct, if you disagree with that, I'd be interested.

Mr. LUTHRINGSHAUSEN. The only reason I ask is that certainly, and my colleagues would get into it as well, I think when you look at the whole issue of regulation and coordinating these three markets that are, in effect, one market, you are talking about other issues besides margins, such as circuit-breakers and front-running, those kinds of things.

Senator DODD. Front-running.

Mr. LUTHRINGSHAUSEN. But the margin issues, I clearly agree with my colleagues on the panel.

The Fed responsibility thing, I think there's a two-fold part of what we are saying about margins. One is Federal oversight, but two is coordination.

So to the extent that the movement of the oversight is to the Fed, that it includes the totally of coordinating these three parts of one market, I think that would represent a reasonable and rational approach to deal with it.

Mr. JONES. But I would just add to that, that on the other parts of the jurisdiction question, I think that it is important that the SEC have jurisdiction to develop consistent regulation.

We have a futures subsidiary, and that reports through the CFTC for pure futures-type of activities, commodity-type activities.

We think the same should be true for security-type activities. It should be identified as securities and approved by the SEC.

Senator DODD. The last question I asked Tom Eagleton was, whether we are looking at something here where the failure to act could create a significant or major financial crisis in this country. What are your views? The three of you.

You sort of indicated that, Jim, in your comments.

FAILURE TO ACT COULD BRING ON FINANCIAL CRISIS

Mr. JONES. I think failure to act could further undermine investor confidence. Failure to act could also exacerbate a problem, as it did in 1987 and 1989.

So that you take the margin question. You have inadequate margins and you raise margins at precisely the wrong time and drain liquidity. That it exacerbates a problem.

Senator DODD. Mr. Hardiman.

Mr. HARDIMAN. The failure to act I think is one that could lead, could not drive, per se, us into another market crisis. But the failure to act could let an event like the UAL buy-out event or another similar event, take us from what should be a relatively minor event in terms of the markets and exacerbate it and push it into a major event.

Senator DODD. Well, that's what I mean by the question.

Mr. HARDIMAN. And that's our major concern, and that is that without this congressional action, the likelihood that what should be minor events in terms of the perspective of the overall market can quickly lead, because of the leverage, the risk, the low margin levels, the lack of liquidity, into a major event.

Senator DODD. Paul.

Senator SARBANES. Well, thank you, Mr. Chairman.

What do you perceive to be the genesis for the fierce opposition to consolidating this regulatory authority in the SEC?

Mr. JONES. Well, I don't know that I could improve upon what Senator Eagleton so eloquently pointed out. He has more first-hand experience at that than I do.

I do think that for the futures markets in Chicago, they do have a great deal of latitude right now without the kind of strong regulatory oversight that the securities markets have. And that's giving up a lot.

Second, not knowing what the future is of stock index futures and knowing how important it is even though it's only about 5 percent of their activities, it's momentarily very important and they don't want to give up to the unknown, I suppose.

But I really couldn't add much to what Senator Eagleton said.

Senator **Sarbanes**. Well, they wouldn't give up the activity. It would just be subject to a different level of regulation.

Is that correct?

Mr. **Jones**. That's correct.

Senator **Sarbanes**. Now what about the argument which—I'm sorry they're not here because the way the hearing was originally to take place, they would have been present at the table with you. I think that would have been helpful.

I assume they will make an argument that this change would place their market in the posture of having to respond to two regulators for different aspects of their activities, whereas now, they respond to only one regulator.

Is that correct?

REPORTING TO TWO REGULATORS

Mr. **Hardiman**. For these activities, they do, Senator. But I would suggest that, just like Mr. Jones pointed out a minute ago, the American Stock Exchange subjects itself to two regulators—the CFTC and the SEC. The New York Stock Exchange does the same thing. The Philadelphia Stock Exchange does the same thing. And I think there's one other, the Pacific Coast Stock Exchange subjects itself to dual regulation currently.

I don't know that any of them have found it to be an onerous burden.

Senator **Sarbanes**. Well, that's helpful. Your view is that the linkage between equity and equity-related products is a more compelling linkage in terms of calling for a single regulator than the linkage of all activities conducted in a particular exchange relating to a single regulator.

Mr. **Hardiman**. Right.

Senator **Sarbanes**. So if you're going to fragment, or if you're going to have a division, you would rather divide the exchange in terms of some of its activities responding to a certain regulator and other activities responding to a different regulator, rather than fragment the regulation of equity and equity-related products.

Is that correct?

Mr. **Jones**. Absolutely. There's so many big differences between commodities and securities-type trading. Customer base is different, et cetera.

We find no problem at the American Stock Exchange for commodities-type trading through the American Commodities Corp., part of our exchange, to report to the CFTC and the securities, equities, options, and would have been index participations reporting directly to the SEC.

Mr. **Hardiman**. Clearly, that's the case, Senator. I think from the securities market perspective, functional regulation, the nature of the activity is more important than the market on which it is traded.

I think that is what we're suggesting here, and that is we're dealing with the overwhelming majority of academics and of regulators and of market participants, has determined on a consistent basis that we're dealing with a single market.

And that it is important from our perspective for enforcement reasons, for margin reasons, for clearance and settlement reasons, to have one regulator of those functions, rather than of the market itself.

Senator SARBANES. Now I'm going to put another question to you, which, again, I would have put first to the other witnesses who unfortunately are not at the table with you. So I'm really asking you to answer what I anticipate their arguments to have been.

I don't fully understand their arguments that the proposals in this legislation are going to drive business overseas. And therefore, that that is a negative aspect of the proposal that the administration has submitted.

What do you perceive that argument to be?

Mr. JONES. Well, I don't perceive what their argument might be in that regard. I can tell you, the way the act is being interpreted, business has already been driven overseas. The product that was designed for two public policy purposes, one, to attract individual retail investors back into the market place and to give them a fair chance to compete with the professionals and institutions. And two, to, at least theoretically, take some of the volatility that might be caused by program taking, that product was shut down and is being traded oveseas.

So I don't understand their argument as to what the rest of this proposal would do, would send other business overseas.

Mr. HARDIMAN. Senator, clearly we're living in a much more global environment, and that applies to the capital markets as well.

All of us are facing increasing competition from overseas for even our fundamental products.

So to suggest that we're going to see more competition from overseas markets in the future is almost a statement of the obvious. It is clearly the case.

I don't know, however, that the jurisdictional shift that we're proposing is going to have any impact on that.

Senator DODD. Well, let me state what I think they're saying.

I think they're saying it's the competition in laxity approach. The idea of having a greater leverage in margins in a foreign market is going to be far more attractive to the person who has found that to be a very attractive way in which to make a buck, and that the SEC is going to regulate this in a far more restrictive way, therefore driving that investor out of the United States to Tokyo or to some other place.

Mr. HARDIMAN. If I could address that, and then Jim can come in.

I think SEC has expressed, and certainly, the current chairman has expressed a keen awareness of the need to meet foreign competition. He's already taken some fairly aggressive steps to do that with this relaxation or the Commission's relaxation of reg. S and the proposal of 144(a), which is now in existence.

So I think he's very keenly aware and the current Commission is very keenly aware of the need to be competitive in global markets.

Senator SARBANES. Let me just interject there.

I, for one, would be prepared to allow some business to go overseas in order not to degenerate to an unacceptable standard of safety and soundness.

Now, you have to apply a rule of reason to this because you obviously want to engage in the competitive environment. But it's quite conceivable that in some of these markets abroad, they may, in effect, have no, or hardly any, standards, and that's obviously going to attract some people in and it's going to give them opportunities that would otherwise not be available, although at a high risk.

It doesn't seem to me that if follows that we have to sink to that level in order to stay in the competitive game. We have to be reasonable about it, but we need to have a standard that makes sense.

And if some people can go out beneath that standard, then we should let it go, in my view.

Mr. **Hardiman**. I concur with that statement wholeheartedly. I would also add to that, Senator, that I think the SEC has been very active in negotiating enforcement agreements and information-sharing agreements with the other major markets of the world.

So that in terms of being able to cooperate in enforcement matters that transcend our borders, they have been, I think, very aggressive in recent years.

REPUTATION OF AMERICAN MARKETS

Senator **Sarbanes**. Would you say that the reputation of the American markets for safety and soundness and integrity has been an asset to them in, in fact, attracting business over the years?

Mr. **Hardiman**. We take the position that well-regulated markets are going to be the markets that will attract the bulk of the business in the capital markets.

Mr. **Luthringshausen**. I would also make the case, Senator, that the major disruptions in our marketplace may affect our ability to compete with overseas markets. I can tell you that in all segments of the market, the futures, the options, and the equity markets, business is down considerably as a result of all of this disruption.

Senator **Dodd**. Let me be a devil's advocate with you here again.

Again, this is something that I presume Leo Malamed would say were he sitting here. When the market breaks occurred, they didn't happen in Chicago. They happened in New York.

What everyone's talking about is something that may happen. But the reality was, in October 1987 and 1989, the problems were generated in New York.

Why are you trying to fix something that isn't broken?

Mr. **Hardiman**. I will come at that by saying, what caused those problems in New York? It was the interrelationship of the markets. And that's just precisely the point we're trying to make today.

I don't think in today's world where you have futures contracts and options contracts and options on indexes and the underyling cash market, that you can isolate one market and say, that is the market that had the problem.

All three of those markets were acting in concert. And what was happening in Chicago, I can assure you was having a very decided impact on what was happening in New York.

Mr. **Jones**. The news event itself may have originated in New York, but that whole triggering event was excerbated by what happend in Chicago. And I don't think there's any dispute about that. And it does need to be fixed.

And as far as Senator Sarbanes' question is concerned, I do think we ought to put in the record, as Senator Eagleton suggested, the innovative, competitive decisions that have been made by the SEC to increase competition and innovation by the SEC. I think it's very compelling.

If you take the options, what they're doing in multiple trading of options, it's going to help the public investor.

It seems ironic to me that, on the one hand, the Chicago markets talk about innovation and competition. I don't understand what they're afraid of, here or overseas. We're not afraid to compete under these rules, here and overseas.

So let's get on with it.

Senator **Dodd**. Thank you. We've got less than 3 minutes on a vote up here.

We'll leave the record open because, obviously, the colleagues who were here this morning may have some additional questions for you.

You answered my question on enforcement, Mr. Hardiman, in the response to one of your other questions. I appreciate that very, very much.

We thank all three of you for being here this morning and we'll reconvene the panel at 1:30.

The committee stands in recess.

[Whereupon, at 12:37 p.m., the committee recessed, to reconvene at 1:30 p.m. of the same day.]

AFTERNOON SESSION

Senator **Dodd**. The committee will come to order.

At this time I would like to invite our third panel to join us at the witness table.

Mr. Bruce Atwater, Jr., the chairman and chief executive officer of General Mills, Minneapolis, MN; Steven Mendell, chairman and chief executive officer, Xoma Corp., Berkeley, CA; John Bachmann, managing principal of Edward D. Jones & Company; Dale Hanson, executive officer, California Public Employee's Retirement System; Robert Kirby, chairman, Capitol Guardian Trust Co.; Thomas Loeb, the president and chief executive officer of the Mell Capital Management Corp.; and Charles Schwab, chairman and chief executive officer of Charles Schwab & Company of San Francisco.

I want to thank all of you for your patience today, and I hope you enjoyed this morning. I saw several of you enjoying the comments of our former Senator Eagleton. He is always colorful and gets to the point.

We appreciate tremendously your willingness to be here today in this matter. As I mentioned earlier, we will be going on for a couple more days. Secretary Brady could not be here with the Houston summit. We were unable to have representatives from the Chicago community as part of the second panel today and that will have to wait for our third day.

So we thank you for coming. All of your prepared statements will be included in the record as if read in their entirely, and I ask you to try and abbreviate, if you can, your comments, and then we'll get to some questions.

So, Mr. Atwater, we appreciate your being with us today and are delighted to receive your testimony.

TESTIMONY OF
BRUCE ATWATER
CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER
GENERAL MILLS, INC.
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

July 11, 1990

Chairman Riegle, and Members of the Committee, I thank you for inviting me to discuss the Administration's proposal for regulatory changes in the stock index futures market.

I am Chairman and Chief Executive Officer of General Mills, Inc. As a major packaged foods company, we have substantial involvement in the commodities futures markets regulated by the Commodities Futures Trading Commission. We are also involved with SEC regulation as a publicly-traded company with equity securities with an approximate market value of $7.5 billion dollars listed on the New York Stock Exchange. General Mills also actively manages about $1.1 billion in pension funds which hold substantial quantities of other U.S. equities traded on markets regulated by the SEC. I think this combination gives us a fairly broad perspective on the subject before the Committee.

I support the Administration's proposal to transfer regulatory authority over the stock index futures market to the Securities and Exchange Commission. I also support the related proposal to give the SEC regulatory oversight over the margin requirements set by the exchanges for stock index futures, similar to the authority the SEC already has with respect to margins for stocks and stock options.

As I mentioned, General Mills participates heavily in the commodity and commodity futures markets. We hold large cash positions in various grains used in our food products and also hold futures positions to offset these cash grain positions. This allows General Mills to avoid the large market exposure of adverse price movement on cash grain positions and allows us to concentrate on the business of handling and processing grain rather than on speculative price moves. Because we are able to limit market risk through the futures markets, we can also establish product prices that are not inflated to protect against unforeseeable market factors.

Our experience in the commodities markets leads us to conclude that they operate extraordinarily efficiently. Transaction costs are low and participation is very broad by both those who want to transfer risk (hedgers) and those who want to assume it (speculators). Clearance and settlement at each exchange is effectively monitored and performance integrity is simply not an issue. In short, we think the agricultural commodities markets operate very well and that the Commodity Futures Trading Commission has been a very effective, knowledgeable regulator of those markets. We would certainly oppose any change from the CFTC as the regulatory body governing agricultural commodities.

It may also be of interest to the Committee that General Mills, like many other companies, actively manages its own pension assets, which includes heavy participation in both the stock market and the stock index futures market.

General Mills' pension fund manager tells me that, while he agrees that equities markets are highly interrelated and need a single regulator providing oversight, the disruptions that occur under the current system give him additional opportunities to make money -- which he was quick to point out he has done successfully. I think I've prevailed upon him, though, to see the bigger picture.

The equities market is currently suffering from loss of investor confidence which has hurt participation, especially of individuals. This loss of confidence stems from two main factors:

(a) Major market disruptions; and

(b) Increasing market dominance by large, sophisticated institutions.

The first factor undermining investor confidence is the frequency and severity of recent market disruptions. The problem is not overall price volatility, but occasional episodes of major disruptions during which pricing relationships between stocks and stock futures break down. Four such episodes have occurred in the last three years, all involving huge one-day selloffs (ranging from 6.9% to 22.6%) under enormous selling pressure from the stock index futures markets. These selloffs were unrelated to any major negative news event.

The second factor is the current dominance of the markets by institutional investors. According to statistics presented in the NYSE's Market Volatility study, institutional investors now account for more than 80% of all stock market trades. Block trades of more than 10,000 share blocks now account for about 50% of all NYSE share volume, an increase from 30% in 1980. At the same time, the amount of major index futures and options contracts traded increased almost tenfold from 1982 to 1987.

Assets under management by institutions year-end 1988 were $5.25 trillion vs. $2.1 trillion in 1981. As of October 1, 1990, 13F managers (institutions managing over $100 million) as a group owned 44.9% of the equities of the 10 largest U.S. corporations and 52% of the equities of the top 50 corporations.

Individual investors have come to believe that these large institutions have an unfair advantage over the individual or small investor (still 55% of the market) through sophisticated trading techniques such as index arbitrage and program trading and that these techniques, especially those involving stock index futures, occasionally spin out of control creating disruptions which unnerve the individual investor who still remembers the various Octobers of 1929, 1987, and 1989.

I should point out that many large institutions are able to profit from sophisticated trading techniques in volatile markets in the same way that General Mills' pension funds can. However, The institutions' short-term trading gains are at someone's expense and the individual investor believes they are at his or her expense.

Loss of confidence by the individual investor dampens participation and hurts the ability of our equity markets to function efficiently in supplying capital -- their primary purpose.

We also need to recognize that stocks, stock options and stock index futures are all part of a highly interrelated, unified equities market.

Because traders in the equity derivative markets can control very large blocks of baskets of stock with relatively small amounts of capital, they can generate enormous selling pressure on the underlying stock. I think it makes good sense to have a single regulator supervising this unified market. In fact, the United States is the only major country where this is not the case. This will assure coordination and rationalization of regulatory policy affecting its interrelated parts -- and consideration of its effects on the underlying stock markets.

Regulation of the equity derivative markets should always be undertaken with at least one eye clearly focused on the effects such regulation will have on the stock market. Regulatory policy should have as its primary goal protecting investor confidence in the integrity of our nation's stock market. I believe that the SEC is best equipped for this job.

I also think that this single regulator should have oversight over the margin requirements set by the respective exchanges for stocks, stock options and stock index futures. I do not contend that margins should be the same in equity and equity derivative markets, for they operate differently. Index futures are based on a broad-based index which is inherently less volatile than individual securities, reducing risk. Also, the futures exchanges require margin levels to be restored within hours and settlement by the next day, in contrast with the longer periods for both on the securities exchanges.

However, I strongly believe that there should be active government oversight of equity market margins by a single regulator.

Margins are a way of regulating leverage in our equity markets. We have had ample experience during the 1980s with excessive leverage and its adverse consequences.

We were told repeatedly during the leveraged takeover craze that highly leveraged balance sheets posed no risk, improved efficiency and had produced no significant failures. Common sense told us otherwise. Now, after a number of junk bond defaults without even a recession, we are seeing the darker side of this phenomenon.

A more spectacular example of the adverse consequences of over-leverage, of course, is the well-publicized S&L crisis. This Committee has delved into this subject far more extensively than I have, but I think you will recognize the familiar pattern: A headlong rush into leverage for short-term gain accompanied by derisive scorn aimed at any suggestion that this constituted a problem that needed regulatory supervision.

I understand that higher margins raise transaction costs and I have no wish to impose unnecessary inefficiencies on any market. But I also think we must learn from recent market disruptions that too much leverage can badly destabilize equities markets when selling pressures pick up velocity. Coordinated margins and stronger capitalization of all parties involved in the equity markets will provide for greater stability and investor confidence. SEC oversight of margins in stock index futures similar to the authority it currently has over margin requirements for stocks and stock options is a prudent, limited step that should reduce the frequency of major market disruptions, reduce the amount of financial distress that accompanies them, and prevent enduring damage to the credibility of our equity markets.

In conclusion, I support the Administration's proposals, and believe that the benefits which I've described of combining the oversight of the equity and equity derivative markets under one regulator would be substantial and would assure equity investors, especially individuals, that their interests were being protected.

Thank you, Senator.

Senator Dodd. Thank you very much.

We welcome you, Mr. Schwab. I introduced you last, and so you're timing was about right. [Laughter.]

Mr. Mendell, you may proceed.

STATEMENT OF STEVEN C. MENDELL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, XOMA CORP., BERKELEY, CA

Mr. Mendell. Thank you, Senator.

I am chairman and chief executive of Xoma Corp. in Berkeley, CA, and my comments today are from the perspective of the smaller capitalization publicly traded company.

Xoma is a leading company in the emerging area of biotechnology and the biophramaceutical area. The company is 10 years old and has traded on the NASDAQ since its initial public offering in 1986.

Early this year I joined the NASD corporate advisory board, and the purpose of that was to try and promote stability overall in our capital markets.

Companies and new industries, such as biotechnology, are particularly affected by the volatility of the stock market and the vagaries of the capital markets. This is because our brief earnings and operating histories essentially require that we rely upon the public markets to raise the capital necessary to fund the research into life-saving new medical treatments.

The cost and availability of capital through equity or equity-like financing is directly influenced by market volatility. When there is no centralized regulatory control, markets are subject to much greater volatility and corporate valuations can be rapidly driven downward as was shown in the market break in 1987. This can significantly affect individual company plans and operations. Investors may refuse to participate in new offerings due to an uncertain after-market and business failure can indeed result.

For example, the market movements of 1987 had a tremendous impact on the biotechnology industry. In fact, after the crash the door was closed for almost 2 years to all but the most costly private financing. So cost of capital became a critical issue for all of us. A number of companies did not survive and several are still struggling to stay above water.

It is clear from our experience that market volatility ultimately can stifle the development of new American industries, and it simply isn't necessary. Companies such as Xoma need stable capital markets in order to carry out business development and expansion. The current regulatory situation has been unable to provide that in many cases.

I think that the fragmented jurisdiction between the Securities and Exchange Commission and the Commodities Future Trading Commission over what is in reality a single market contributed significantly to the market volatility in 1987 and 1989, and I think some of the rationale put forth by Mr. Atwater is absolutely correct.

Clearly there is a need to assure that adequate regulatory safeguards are in place and that regulators can respond swiftly and uniformly in times of market stress. So it's also important that we have a balanced market, a market balanced of institutional investors along with the private investors. This reduces overall volatility and prevents concentration of overall control.

I think that this need can be met by assigning a single regulator to a single market, and for this reason the Brady proposals make a lot of sense to me.

I urge your support of the Capital Markets Competition, Stability, and Fairness Act and suggest that the Congress give its early attention to the passage of this important and sensible regulatory reform.

Thank you.

Senator Dodd. Thank you very much, Mr. Mendell.

[The complete prepared statement of Steven Mendell follows:]

REMARKS OF
STEVEN C. MENDELL
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
XOMA CORPORATION, BERKELEY, CALIFORNIA
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
JULY 11, 1990

Thank you, Mr. Chairman and members of the Committee. I am pleased to have this opportunity to testify in support of the Capital Markets Competition, Stability and Fairness Act of 1990. This legislation evolved in part as a result of the Brady Commission's review of the causes of the October 1987 stock market break. The more recent market break this past October reminded us of the need for unified regulation of stocks and stock-index futures under the Securities and Exchange Commission.

My comments today are from the perspective of the small-capitalization, publicly traded company. XOMA Corporation is a leading company in the emerging biotechnology and biopharmaceutical industry. The Company is ten years old and has traded on NASDAQ since our initial public offering in 1986. Earlier this year, I joined the NASD Corporate Advisory Board and have great interest in supporting efforts to promote stability in our capital markets.

Companies in new industries such as biotechnology are particularly affected by volatility in the stock market. This is because our brief earnings and operating histories essentially require that we rely upon the public markets to raise the capital necessary to fund research into life-saving new medical treatments. The cost and availability of capital through equity or equity-like financing is directly influenced by market volatility. When there is no centralized regulatory control markets are subject to much greater volatility and corporate valuations can be driven rapidly downward. This can significantly affect individual company plans and operations. Investors may refuse to participate in new offerings due to an uncertain aftermarket, and business failures can result. For example, the market movements of 1987 had a tremendous impact on the biotechnology industry. After the crash, the door was closed for almost two years to all but the most costly private financing. Although XOMA had a strong cash position in 1987, many other companies did not. A number of these companies did not survive and several are still struggling to stay above water. It is clear from our experience that market volatility ultimately can stifle the development of new American industries, and it simply isn't necessary. Companies such as XOMA need stable capital markets in order to carry out business development and expansion. The current regulatory situation has been unable to provide that stability.

The fragmented regulatory jurisdiction between the Securities and Exchange Commission and the Commodities Futures Trading Commission over what is in reality a single market contributed significantly to the market volatility in 1987 and 1989. Clearly, there is a need to assure that adequate regulatory safeguards are in place and that regulators can respond swiftly and uniformly in times of market stress. This need can be met by assigning a single regulator to a single market. For this reason, the Brady proposals make sense to me. I urge your support for the Capital Markets Competition, Stability and Fairness Act and suggest that the Congress give its early attention to passage of this important and sensible regulatory reform.

Thank you.

Steven C. Mendell is Chairman and Chief Executive Officer of XOMA Corporation, 2910 Seventh Street, Berkeley, CA 94710. For further information contact Mr. Mendell or Carol DeGuzman, Director of Corporate Communications at (415) 644-1[illegible]70.

Senator DODD. Timing is everything, and the Senator from Missouri has arrived just in time to introduce his constituent if he would so like.

Senator BOND. I will be very brief, Mr. Chairman.

John Bachmann and I have been friends for more than 20 years. He heads a very significant brokerage firm, Edward D. Jones in our State. He has served as president of the SIA and has a number of distinctions and honors and credits.

Senator BOND. John, we are please to have you with us.

STATEMENT OF JOHN W. BACHMANN, MANAGING PRINCIPAL, EDWARD D. JONES & CO., ST. LOUIS, MO

Mr. BACHMANN. Thank you, Senator Bond. I wouldn't dispute a word of that. [Laughter.]

Thank you for giving me the opportunity to come and speak on behalf of a constituency that I think has not been heard from yet. In explaining that, I am the managing principal or managing partner of Edward D. Jones & Company, and we have 1,600 retail officers in 43 States around the United States serving approximately one million retail customers.

Our entire business is the retail securities business serving individual investors. Of that one million customers, we would estimate that about 150,000 would be farmers or retired farmers, and I think it's significant to make note of that fact that farmers are investors, too, and we have in preparation for this time checked carefully with them for their views, and we find no connection between the farm lobby and farmer investors in terms of views on this issue.

Investors still own American industry, whether the figure is 55 percent, as Mr. Atwater suggested, or 60 percent as some other studies suggest. People confuse trading volume on the stock exchange with who actually owns America, and America is still predominantly in the hands of individuals.

We support the proposal before us, and we support it in part because our customers are frightened, they are confused, they are becoming angry and cynical, and they see themselves as captives of a system that is out of control.

We have experienced two market crashes in 1987 and 1989 which studies suggest were not driven by economics, but were sparked by innovative products and innovative trading techniques which pushed the market up as well as down. I'm talking about index arbitrage and portfolio insurance as the two principal examples.

After each of these market crashes significant studies, serious studies arrived at the same conclusion. One, there should be a single market regulator and, two, there should be a single margin regulator, and yet we still wait.

After 1987 customers were generally stunned and confused. After 1989 we found our customers to be angry and cynical, and the question comes, why aren't investors speaking out? Investors are speaking out every day. They are voting with their check books, with their pocketbooks, and what they are saying is we need to put an increasing portion of our assets in places that are not subject to these kinds of risks, and this comes at a time when our Nation is saying we need more equity, we need more investors and we need less leverage.

I think it's a sad commentary to say, and I give an exact quote of one of our customers: "I'm afraid to invest in America."

In addition to my role at SIA, as Senator Bond pointed out, I served for 2 years as the chairman of the Securities Industry Association, which is the trade association serving our industry, and as luck would have it, my tour was both during and after the market crash. I made many trips to Washington, to Chicago and to New York visiting with self-regulators, regulators, firms and members of the public. I was before the Senate Banking Committee on these matters.

There was one common thread that came through no matter who I talked to or where I went, and that was if we were to design the system today, we would never design it like this.

Well, you know, we have a single market for equities, and I think that has been clearly demonstrated, and yet we have two regulators with different constituencies with different styles. I guess as one of our former witnesses would say, we have two cops and one intersection.

Today the system guarantees ambiguity, but we have a chance before us right now to fix it, and it concerns me very much that we take full advantage of this. Regulation does not precede innovation. One doesn't anticipate, one reacts. We have seen innovation, and we have seen what innovations can do with the old regulatory system, and what we seek to do now is nothing more than line up current regulation with current reality.

It would be an act, in my view, of high statesmanship for those interested parties to agree now to put in place a system with a single regulator. This does represent less than 5 percent of the CFTC jurisdiction. The SEC does have a wealth of experience in dealing with equities and equity markets.

In my view, it would strengthen greatly the CFTC freeing them from this jurisdiction over these very different kinds of instruments and different kinds of markets, and in my view it would do a great deal to create respect for the CFTC, respect which I think would be forthcoming were this to happen. It would be the strongest possible signal to individual investors and not simply individual investors, but other investors as well that we are serious about this, that we are going to deal with this issue.

It's my belief that these changes are going to take place. They can take place now. We have some experience and we can act in anticipation of to head something off or I fear they can happen later at a time when it will come at great cost to the American people.

Therefore, we strongly recommend the adoption of the legislation before us.

Senator HEINZ [presiding]. Mr. Bachmann, thank you very much. Senator Dodd had to take a telephone call.

[The complete prepared statement of John Bachmann follows:]

Edward D. Jones & Co.
Member New York Stock Exchange, Inc. and Securities Investor Protection Corporation

TESTIMONY OF

JOHN W. BACHMANN, MANAGING PRINCIPAL
EDWARD D. JONES & CO.

CAPITAL MARKETS COMPETITION, STABILITY, AND FAIRNESS ACT OF 1990

BEFORE THE UNITED STATES SENATE
COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS

JULY 11, 1990

201 PROGRESS PARKWAY
ST. LOUIS COUNTY
MARYLAND HEIGHTS, MISSOURI 63043-3042
(314) 851-2000

Testimony of

John W. Bachmann
Managing Principal
Edward D. Jones & Co.

Before the
U.S. Senate Banking Committee
July 11, 1990

Mr. Chairman, I appreciate the opportunity to appear before this Committee to present the views of Edward D. Jones & Co., and more importantly, to communicate to you the viewpoint of our customer constituency regarding financial regulation and jurisdictional issues.

By way of background, Edward D. Jones & Co. is a stock brokerage firm and it is a member of the New York Stock Exchange. We have 1,600 branch locations from coast-to-coast, but our offices are primarily located in the mid-western states with more than half in communities of under 30,000 population. As I relay to you the convictions of our clients, you should understand that our firm does not deal with institutions nor does it cater to wealthy clients with large portfolios. On the contrary, we work strictly with individual investors, generally of moderate means. More than any other firm, we are the broker to rural America. Although our firm is on the opposite end of the spectrum of the New York firms dealing with enormous institutions with sophisticated trading techniques, we believe that nonetheless it is appropriate for us to acquaint you with the viewpoint of individual investors because, in fact, we are one of only five firms in the entire securities industry to have over one million active customer accounts. Moreover, in January of 1987 I became Chairman of the Securities Industry Association and was serving in that office when the market break of 1987 occurred. Because of the intense aftermath scrutiny, I served as Chairman a second year to provide continuity to the process of studies and hearings that followed, and have remained vitally concerned with these issues to date.

In recent years, it has become apparent that individual investors are deeply troubled with the current state of the financial market. Although we tend to visualize a marketplace today dominated by institutions, in fact individuals own directly 60% of stocks in America. They are the investors so vital to our deteriorating capital formation ability in this country. Individuals tend to truly buy for long-term investment purposes as opposed to institutions with their penchant for short term trading. We simply dare not let the current state of the markets continue to justifiably frighten these individual's savings away from American industry. Our market research together with informal feedback from these clients has made us aware that their primary fear focuses on the recent incredible volatility in financial markets. Frankly, we've detected an alarming fear never previously expressed by these individuals when discussing America's greatest blue chip corporations stemming from their trepidation about market volatility. For example, last week in response to some market research, we consistently heard a theme of being "...afraid to invest in America." The comments of a Virginia farmer were typical when he said the only stock he would invest in was livestock because at least he could eat it if the price dropped dramatically. A Wisconsin dairy farmer told us, "...The market is getting jerked around. How can somebody like me be treated fairly when the market is going from one extreme to another. If milk prices were this way, I wouldn't farm."

The volatility which is driving investors from the markets goes beyond the traditional measures of volatility, i.e. price changes from day-to-day. A new and sometimes vicious variation of volatility occasionally whipsaws our markets - intra-day volatility which witnesses the market rise or fall 100 or more points in a matter of minutes. Although the market may end unchanged by the close, the wild intra-day swings unsettle even the most seasoned investor. And frankly, it has considerably frightened the average investor. There is a direct relationship between the use of stock index futures and the intra-day volatility of the stock market. Several studies have demonstrated this relationship.

As an organization directly tuned to the opinion of such individual investors, we know that their confidence in our securities markets is extremely low. It is vital that this confidence be restored. In our opinion, we do believe there is a relationship between stock index futures (and options thereon) and this intra-day volatility. We simply cannot afford to ignore the concerns of the investing public and this nation's responsibility to insure the integrity of the securities markets. In addressing this problem, we find that having differing regulators serving generally different constituencies with varying regulatory frameworks has become obsolete due to the recent proliferation of new derivative financial instruments. There exists a regulatory gap evolving from inadequacy of coordination on the regulatory effort. I am here today to urge you to plug this gap. In essence, we seek legislation to grant a single regulator oversight authority and responsibility for all equity-related products. Similarly, we believe this sole regulator should have authority for setting forth margin policies on these equity-related products. It is our conviction that establishing the Securities and Exchange Commission as this regulator will make great strides in restoring investor confidence in our markets and, hopefully, lead to a more uniform, streamlined and improved regulatory framework for assuring the integrity of the securities markets. These recommendations are not new and have been endorsed in one form or another by the majority of industry and government groups which have devoted much time and effort to study the issue, including; the Presidential Task Force on Market Mechanisms; the U.S. Treasury, the Securities & Exchange Commission; the Federal Reserve Board, the New York Stock Exchange's Blue Ribbon Panel, the Securities Industry Association; major securities firms including those who are some of the principal participants in both the securities and futures markets as well as members of the House and Senate, some present today.

In 1988, during my tenure as Chairman of the Securities Industry Association, when meeting with various groups involved with studying the market break and attempting to mend the markets, I was struck by one overriding concept. There was unanimous agreement among these groups of regulators, exchanges and elected officials, that if one were starting today from scratch to develop a regulatory framework in this area, it would not resemble today's system. Clearly, if equity index futures had existed alongside agricultural commodity contracts in the formative years of today's regulation, we would have recognized from the outset the mistake in lumping stock market related products with agricultural instruments. Our current bifurcated system is obsolete and it is dangerous to permit it to continue. We urgently need a single regulator for all equity-related products. In our opinion, we should appoint the SEC to this role as it is looked upon as the ultimate force for public protection of the equity markets and investors since its establishment in 1934.

We have been apprised that there is a conflict between the SEC and the CFTC in what some have characterized as a jurisdictional land-grab in this area. Once again, based upon our experience in having been directly regulated by both entities, it is our opinion that the Securities and Exchange Commission is a preferable regulatory choice for this legislative thrust. Although both are competent agencies, the SEC's historical expertise in equity and equity-related products makes them the logical choice. We have heard arguments raised that in rural areas, farmers are purportedly more familiar with the work of the CFTC and that they would be the favored regulator. However, our dialogue with farmers and other individuals living in rural communities simply fails to confirm this notion. We have found no appreciable level of support among rural investors for CFTC jurisdiction or any preference for the CFTC over the SEC within this constituency. A recent conversation with a client in Kentucky is instructive when he indicated his familiarity with the CFTC through his farming livelihood, but is familiar with the SEC through his investments. In essence, we believe that the CFTC should regulate non equity related commodities, but that the SEC needs to be in charge of products related to the stock market. Such a move will not be disruptive to the CFTC because stock index futures constitute only 5% of the futures contracts under their jurisdiction.

In summary, our customers inherently understand that a sensible step in solving their deep-rooted fears over the volatility in the securities market is the designation of a single regulator. They sense that stock index futures are more clearly tied to the equity markets than traditional commodity contracts drawn upon pure agricultural products. Accordingly, they look to the entity having the greatest experience and best track record in dealing with equity-related securities as the logical choice as the regulator.

In my opinion, these changes will ultimately happen whether in current legislation or in the aftermath of another market disaster. I can only express my hope that you are prepared to make the necessary remedial changes now rather than wait for another market panic with the accompanying devastating results to prove their necessity.

I appreciate the opportunity to provide this Committee with the input of our firm and more importantly, to relay to you the predominant sentiment we hear from our individual customers including those from the rural areas we serve. Thank you for the opportunity to appear before you today and I look forward to providing you with any further information in the future you might request on these issues.

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THE WALL STREET JOURNAL MONDAY, JUNE 18, 1990

Advertisement

The Individual Point of View

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A Call to Action

The stock market's record performance during recent months has created a new optimism about the return of the individual investor to the equity markets. At Edward D. Jones & Co., we believe that equities play a vital role in securing the future for individuals. We are among those most anxious to see individuals' confidence in equity investments restored. But our enthusiasm is tempered by concern.

Investor confidence suffered its most serious blows when speculative trading strategies triggered alarming market drops on October 19, 1987 and October 13, 1989. The market's recent strength may have dimmed the memory of those events, but the trading practices that caused them are still in place.

At Edward D. Jones & Co., we have taken every opportunity to call the attention of our industry and our legislature to the negative effects of increased market volatility.

At this very moment, an important discussion is taking place in Congress which gives individuals an excellent opportunity to voice their own concerns about market volatility. This opportunity, however, will not last long. Individuals who feel it is important to speak out, must do so immediately.

■ ■ ■

Right now, the Senate is considering legislation which, if approved, would tighten controls on the types of computer-program trading strategies that have been blamed for the stock market's 500 point plunge on October 19, 1987, and its 190 point drop in two hours of trading on October 13, 1989.

The proposal calls for the regulation of the market for stock index futures to be transferred from the Commodity Futures Trading Commission (CFTC) to the Securities and Exchange Commission (SEC), which already has responsibility for regulating trading in the stock markets. Stocks and stock index futures are closely linked. Regulation of trading activities in these markets by a single agency would make it easier to detect and control practices which can trigger huge market swings over very short periods of time.

In addition, the proposal calls for margin requirements to be set by a single regulator. Low margin requirements in the futures market could encourage speculation, creating the potential for increased volatility that could spill over into the stock markets.

Opponents are trying to block these much-needed reforms by suggesting that they will eliminate demand for products traded in the futures markets. We disagree. Trades of stock index futures comprise only about 5% of the volume traded in the futures exchange. The transfer can be made without significant disruption to the futures markets or to the activities of the CFTC.

The Secretary of the Treasury, the Chairman of the Federal Reserve and the Chairman of the SEC have all endorsed the Administration's proposal to provide one regulator for a single market of stocks and stock index futures. Grass roots support from individual investors, however, is critical.

■ ■ ■

Collectively, individual investors own more than 50% of all common stock outstanding, but they have been steadily liquidating their equity investments. Since 1970, equity investments have declined from 36% to 20% of household financial assets.

High-quality equity investments provide the growth potential necessary to protect long-term savings from the effects of inflation. Historically, they have outperformed all other types of investments. Yet, because of excessive market volatility, individuals are not taking advantage of the investments that are best suited to help them provide for the future.

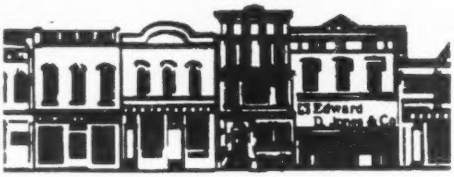
Individual investors' concern regarding the equity markets also threatens to further erode our nation's savings rate. Although it is increasing somewhat, in 1989 the U.S. savings rate hovered around 5% of household income, compared to 15% in Japan and 12% in West Germany. Our diminished savings rate threatens our ability to compete internationally. The U.S. is part of a global economy and is in danger of being left behind.

■ ■ ■

At Edward D. Jones & Co., we believe that immediate action must be taken to control the practices which create extreme volatility in the equity markets.

Equity investing is important to the long-term financial health of individual investors and of our nation. We believe that the Capital Markets Competition, Stability and Fairness Act of 1990 represents an important first step in curbing excessive market volatility.

If you believe that this is an important issue, don't miss this opportunity to speak out. All Members of Congress can be reached by calling the Capitol Switchboard at (202) 224-3121. Please contact your Senators today.



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Edward D. Jones & Co

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Attachments

IR NAME	BR & IR #	COMMENTS
Ken Surber Harrisonburg, VA	267628	Had a farmer in '87 that said the only stock he was going to invest in was livestock. At least he could eat it if the price dropped dramatically. All my farm relatives and friends in the Midwest have said many times that they would prefer the futures markets, not mess in their markets either.
Bob Greenly Alliance, OH.	446530	Had a very active client who has not traded since the UAL fiasco in October. He was thinking of buying UAL, but when he saw the wide fluctuations, he said, "This is no place for small potatoes like me". You might be interested to know that his net worth is over $600,000. Many people are saving with a very low interest savings accounts, which puts a burden on social security and other programs.
Tom Thompson Hardy, AR.	728919	There are several occasions that there were too many 'Gamblers now in the market which created too much volatility.' The crash of '87 only intensified the belief. Frankly my client is petrified of the NYSE gyrations. Many of my other clients are retired and simply will not subject themselves to periodical 50 point gyrations in one day. Any thing that can be done to return some stability, even if its just in their minds will be welcome.

IR NAME	BR & IR #	COMMENTS
Bob Harter Rochelle, IL.	605345	All my life I've bought/sold stock, but when you get moves of 30 and 500 points in one day, it's ridiculous, (It used to be 10-15 points.) There is feelings that if you buy one day, you could wipe yourself out the next. This man has always bought good, high quality blue chips, but has been scared out since '87.
Bill Haeffner Lodi, CA.	840522	1. Bud feels that the market is not safe enough to invest in now. Until the market stabilizes he will not invest into equities. He will only deposit funds in banks in insured accounts for 80% of the money he controls, the rest in tax free bonds. 2. My decision to only go with fixed CD's and money market accounts was based on the inherent inability of the government to regulate the stock market shown by the inability to come to some grips with undue market volatility. They were afraid to put their money at risk. 3. Had clients that used to buy utility stock, but after October '87, they have not bought one stock. Because of market volatility, they want to be able to liquidate at any sign of inflation and higher interest rates. They have lost confidence in the government's ability to run the countries economy and has irresponsible for creating this high bill to pass on to their grandkids.

IR NAME	BR & IR #	COMMENTS
		4. It was agreed that the volatility and market being so high at the time of liquidation of 3 1/2 million worth of stocks made them feel that to take the bird in the hand now would be a better move than waiting on an insecure and scary market for 8 months. His cash has been sitting in a DPTC account and will not move it into the market because he feels that now is not the time to be investing, even since before he was nearly fully invested.
Charles Pockras Circleville, OH.	431431	Had a client that invested for 25+ years sell most of her Coca-Cola stock because of October '87 and '89. In January she did purchase a global bond fund. She perceived this to be less volatile and diversifying outside of the U.S. This is the kind of long-term conservative investor that volatility is spooking out of the U.S. market.
Ron Covington Blufton, IN.	987494	A farmer client said they would like to see the SEC regulate the commodities markets if it will reduce market volatility in the equity markets. Hugh realizes that most of the damage that the market crash of '87 caused, was the result of illegitimate investing techniques and not the result of the market simply being "too high". His inclination was to leave the market.

IR NAME	BR & IR #	COMMENTS
Arnie Knecht Lancaster, TX	145908	Comments heard frequently from farmers. "Damn, farming is enough of a crap shoot these days. I don't need to be shooting dice in the stock market." "if I want to play in a casino, I'll go to Vegas. I don't want to take that kind of risk with my money." By scaring away individual investors, the stock market is seriously threatening long-term investors by encouraging them to keep all their money in short-term instruments.
Van Pearcy Midland, TX.	792464	My client is overly hesitant to invest in the market because of the huge swings. Feels the "little man", "mom & pops" have no say and no control because only large corporations, government have control.
Lief Nelson Topeka, KS.	981236	Have a couple of customers who no longer trust the stock market because of volatility, mainly because of October '87 experience.
Bob Shillingstad Richland, WA.	840190	My clients transferred all of their utility stocks and Washington mutual account to bonds and CD's because of volatility in the market. Bob said over and over that the market is no place for the small investor. He doesn't trust it.

IR NAME	BR & IR #	COMMENTS
Randy Gershman Marshfield, WI.	539522	Dairy farmer said, "The market is getting jerked around, how can somebody like me be treated fairly when the market is going from one extreme to another, If milk prices where this way, I wouldn't farm."
Peter Gauthier Plaquemine, LA.	333772	A sugarcane farmer hasn't made an equity investment of any kind since '86 because he has no faith in the market. Mainly feels that few are controlling and manipulating stocks to the extent that the small investor has no chance to make any money.
Jim Hall Pepper Pike, OH.	440440	Because of excess volatility, have no farmers. One customer quit after the '87 crash.
Sandy Sarillo Lombard, IL.	211539	Since the crash of '87 stocks that involve a commodity or raw material are tough to sell. The clients don't buy because they are afraid of any stock that has to do with a commodity. I only call with "safe" stocks.
Mark Bachman Lapeer, MI.	481170	1. My client is in favor of SEC regulation of SIFT. The only money he puts into the stock market is that which he feels he can afford to lose. He doesn't want to take big chances with the market and his very limited stock holdings.

IR NAME	BR & IR #	COMMENTS
		2. A cash crop farmer is in favor of the SEC in charge of the regulation of Stock Index Futures. He is concerned about drastic market fluctuations. He is tempted to sell his stock holdings for fear of large market swings.
Bill Edwards Aberdeen, SD.	573515	Had a couple invested in Keogh plan and when they heard about October '87, they called to sell out. That was a bitter experience for them. They lost faith in the system, withdrew all their investments, and have essentially stopped investing in America.
Cindy Stephens Sulphur Springs, TX.	758345	Have a client who after the October '87 disaster moved his money from Colonial Fund to a Money Market Account and will not move back into the market. During reviews with him, he comments that they cannot stand to watch their principal fluctuate so wildly. They are dairy farmers and understand risk, but market volatility has sent them to the sidelines.
Mike Fedler Ashtabula, OH.	443420	10-15% of my client base has not gone back in the market, or has thought about it because of negative response. Farmers are not the only ones that have gotten out of the market because of the volatility.

IR NAME	BR & IR #	COMMENTS
Robin Hovis Millersburg, OH.	946370	A local dairyman is very disillusioned with the market volatility. He feels like his money is made a joke of by "Wall Street Smart Alecks" who are not accountable for reckless behavior.
John Haley St. Cloud, FL.	360922	Farmers are probably the most adamant in their condemnation of the volatility of the markets. Attitudes are hostile and are perceived to be manipulation of the markets by commodity interests attempting to generate personal profits.
Donna Bradshaw Hot Springs, AR.	719260	One fourth of our clients are staying out of the market right now because of fear of market volatility.
David C. Bruns Washington, IA.	918344	Had a client who got spooked out of the market by volatility. He said he was fed up with this roller coaster and liquidated his fund shares and put them in a money market account.
Wayne Petty Athens, AL.	363270	Because of the crash in '87 a second generation farmer sold everything because it scared him out of the market. He intends to stay out for good.

IR NAME	BR & IR #	COMMENTS
Jack Scott Elizabethtown, KY.	962418	1. The farmers in my area have great animosity toward the Chicago Board of Trade. He does favor stock index futures being governed by the SEC. 2. Stock index futures trading does not belong in the commodities sector but with SEC.
Peter Keay Owosso, MI.	807227	Many clients have cashed in their stock and have never returned since to the equity markets. Some comments are: "Its not worth it to me to have my savings and investments seesaw in value so quickly, I'd rather take a lower rate and know my principal is safe." "I don't want to have to go back to work again. It's not worth it to me to potentially loose huge amounts of my savings in one day in the stock market." Volatility of program trades ultimately scared my clients into their current thinking.

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Summary of Testimony of

John W. Bachmann
Managing Principal
Edward D. Jones & Co.

Before the
U.S. Senate Banking Committee
July 11, 1990

- Congress should ratify proposed legislation which would consolidate oversight and regulation of all equity and equity-related products including stock index futures, under the SEC.

- Congress should establish one regulator for margin on all equity related products.

- Edward D. Jones & Co. represents over 1,000,000 retail customers, many of whom are farmers or retired people, who have become afraid to invest in equity because of extreme market volatility.

- When acting as Securities Industry Association Chairman in 1987-1988, I discovered that all groups affected by the crash of '87, whether representing the regulators, the exchanges or the SRO's, agreed that if stock index futures had existed alongside stocks earlier in the century, the regulatory system would never have been designed as it is.

- Farmers are also investors, and they demonstrate their distaste for market volatility by moving savings into cash and CD's at a time when the impact on capital formation puts the U.S. economy at a competitive disadvantage.

- Groups endorsing these recommendations include industry and government officials who regulate, trade, or deal in, both commodities and stock.

- These recommendations will be implemented, whether now, or later following another stock market crash.

- Unified regulation would give the regulator authority, not only to implement rules particularly regarding economic cost which would apply equally among the interrelated equity markets, but also to clarify the distinction between transactions and ownership.

201 PROGRESS PARKWAY
ST. LOUIS COUNTY
MARYLAND HEIGHTS, MISSOURI 63043-3042
(314) 851-2000

Senator HEINZ. According to the witness list, Mr. Hanson would be next.

STATEMENT OF DALE M. HANSON, EXECUTIVE OFFICER, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, SACRAMENTO, CA

Mr. HANSON. Senator Heinz, members of the committee, it is my pleasure to appear before you today.

As Senator Dodd had mentioned in his introduction, I am the chief execuive officer of the California Public Employee's Retirement System.

By way of background, the California Public Employees' Retirement System is the largest public employee retirement system in the Nation with assets of over $58 billion and nearly 870,000 active and retirement beneficiaries covered under the system.

California Public Employees' Retirement System is a major investor in America's public traded corporations. Our equity portfolio includes investments in over 1,300 U.S. publicly traded companies, and these investments have a current market value of $22.4 billion.

California Public Employees' Retirement System is a long-term investor. Our long-term perspective results from our belief that short-term investment horizon is inconsistent with our fiduciary duty to fund retirement benefits for the beneficiaries of our fund.

Our role as a long-term investor of American corporations is reflected in the fact that the average holding period for equity investment in our portfolio is nine years. Our turnover last year in our equity portfolio was 7 percent, which interesting enough is about one-half of what the total turnover was in the New York Stock Exchange in 1960.

So California Public Employees has distinguished its equity investment as committed or patient capital. For example, during the 30-day period following the so-called market break of October 19, 1987 while many institutional and individual investors were fleeing the equity market, the California Public employees quietly and with little fanfare committed over a billion dollars in the equity market during that 30-day period following October 19.

That came on the heels of the first 19 days in October where we watched our equity portfolio downsize by $7 billion—that is with a "b" billion.

Therefore, as a major and long-term investor in domestic companies and as a representative of nearly 870,000 individual beneficiaries, we take great interest in the current discussions regarding the regulatory jurisdiction of the SEC and the CFTC.

Our concern stems from our commitment to do everything possible to enhance the competitiveness of American corporations and the capital markets for such corporations within the framework of our fiduciary obligation and our overall investment philosophy.

Given the commitment of the California Public Employees' Retirement System to the competitiveness of American corporations and the capital markets for such corporations, we believe the administration's legislative proposal provides a thoughtful and constructive starting point balancing in part the number of divergent views that have been expressed regarding certain of these issues.

CalPERS urges consideration of the proposal, not from the standpoint of personalities or regulatory gamesmanship, but in light of the need for American capital markets to remain competitive on a global basis, goal that is handicapped by the regulatory and market fragmentation that exists today.

That concludes my statement.

Senator HEINZ. Thank you very much, Mr. Bachmann.

[The complete prepared statement of Dale Hanson follows:]

TESTIMONY OF

DALE M. HANSON, CHIEF EXECUTIVE OFFICER
CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
CONCERNING REGULATORY STRUCTURE OF UNITED STATES SECURITIES MARKETS

BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE COMMITTEE OF BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

July 11, 1990

Chairman Dodd and Members of the Subcommittee:

It is my pleasure to appear before you today to discuss certain matters of concern to the California Public Employees' Retirement System (CalPERS) regarding regulation of the American capital markets and the impact of that regulation on the competitiveness of American corporations and the capital markets for such corporations in the global economy.

By way of background, CalPERS is the largest public employee retirement system in the nation, with assets of over $58 billion and beneficiaries consisting of nearly 870,000 active and retired public employees. CalPERS is a major investor in America's publicly traded corporations. Our equity portfolio includes investments in over 1,300 U.S. publicly traded companies which investments have a current market value of approximately $22.4 billion. CalPERS also has $3.5 billion invested in international equities.

CalPERS is a long-term investor and generally does not engage in active trading of equity securities. Our long-term perspective results from our belief that a short-term investment horizon is inconsistent with our fiduciary duty to fund retirement benefits for the beneficiaries of our fund. Our role as a long-term owner of American corporations is reflected by the fact that the average holding period for an equity investment in our portfolio is nine years.

CalPERS has distinguished its equity investments as "committed" or "patient" capital. For example, during the 30-day period following the so-called "market break" of October 19, 1987, while many institutional and individual investors fled the equity markets, CalPERS quietly and with no fanfare invested nearly $1.0 billion in equities. This decision followed a loss in market value to CalPERS of nearly $7.0 billion during the first 19 days of October. CalPERS' investment decisions were based upon our belief that the drama that had occurred in the financial markets had little or no relationship to the underlying strength of the United States economy. Similarly, following the 191-point, 6.9% decline in the Dow Jones Industrial Average on October 13, 1989, which had an approximately $1.7 billion impact on CalPERS, we continued to support the market in the buying mode.

With this background, as a major and long-term investor in domestic companies and also as the representative of nearly 870,000 individual beneficiaries, we take great interest in the current discussions regarding regulatory jurisdiction of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). Our concern stems from our commitment to doing everything possible to enhance the competitiveness of American corporations and of the capital markets for such corporations, within the framework of our fiduciary obligations and our overall investment philosophy. Given our position and concern, we cannot stand on the sidelines during any debate among so many government officials and agencies, as well as industry representatives, regarding issues of importance to the future of the nation's capital markets.

Since the market break of October 1987, there have been numerous public and private studies about various aspects of the United States' capital markets. Many of the points raised in such studies lead us to be concerned about the present condition of our capital markets. For example, SEC Chairman Richard Breeden noted in a recent speech that a decade ago the United States' equity capital market was approximately four times the size of Japan's; today, Japan's market capitalization is almost equal to ours. Also, in 1986 the United States markets accounted for nearly 98% of all stock index futures contracts traded worldwide; in 1989, the United States markets accounted for just 49% of the aggregate dollar value of such contracts. 1/ Dr. Wendy L. Gramm, Chairman of the CFTC, told this Subcommittee that, "since 1985, United States equities have declined from 75% to only 25% of the world equity markets." 2/ As a large investor in domestic companies, CalPERS is concerned that these figures reflect a reduction in

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1/ Remarks of Richard C. Breeden, Chairman of the SEC, before the Mid-America Committee, May 1990.

2/ Statement of Dr. Wendy L. Gramm, Chairman of the CFTC, before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs of the United States Senate, March 29, 1990.

confidence and competence in the United States capital markets in favor of rapidly developing international markets.

No single factor can explain the reduced competitiveness of the United States' capital markets. We are concerned, however, that while international markets appear to be working towards unified legal and regulatory structures such as the European Community, the United States is burdened with an increasingly complex legal and regulatory structure. In the United States, companies coming to market face not only rigorous federal regulation but also separate and often quite distinct "blue sky" securities and corporate laws of 50 states. Over the past decade, we have seen many states enact highly specialized laws in response to transactions involving specific companies. These laws then become part of the crazyquilt of regulation that burdens our capital markets and weakens the value of long-term investments. As a result, the value of American corporations to the investing public is, in many respects, dependent on the state of incorporation rather than the fundamentals of the business. These competing State laws are a prime example of how a single economic system can be disrupted and distorted because of a lack of uniform regulation.

The complexity of American corporate law and securities regulation at the State level is further compounded at the federal level. The jurisdictional dispute between the SEC and the CFTC is but one example of increasingly overlapping and competing federal regulatory authorities. It is not unusual for capital raising transactions in America to be subject to jurisdiction of four or five different agencies, often with interests in related areas. CalPERS is concerned that as international markets streamline their legal and regulatory structures, the complexity of the United States' regulatory system will make the cost of raising capital in our domestic market too expensive relative to the availability of capital in the rest of the world.

In connection with these hearings, as well as hearings before other committees of the United States Senate and House of Representatives, we have heard concern for the condition of the United States' capital markets expressed by the Department of the Treasury, the SEC, the CFTC, the Securities Industry Association, the New York Stock Exchange, and others. It is clear to CalPERS that, given the questions raised in many quarters, a number of issues must be explored and evaluated by the Congress.

The Bush Administration has recently provided a legislative proposal, the "Capital Markets Competition, Stability, and Fairness Act of 1990," to address certain concerns that have been expressed regarding the nation's capital markets. In general, the Administration's proposal includes the following proposals:

- Transfer of regulation of stock index products from the CFTC to the SEC.
- An exception to the exclusivity provision of the Commodity Exchange Act to provide that certain financial instruments with elements of "futurity," such as government securities, will be subject to SEC regulation.
- Consolidation of regulation of margin requirements on all stock index products in the SEC.

According to SEC Chairman Breeden, the proposed legislation accomplishes the following objectives: (i) harmonization of regulation of margin on all equity products; (ii) protection of the competitiveness of the United States' capital markets; and (iii) protection of market stability and deterrence of intermarket fraud. He further states that the SEC believes the Administration's proposal will make the financial regulatory system more efficient, stable and creative, thereby resulting in reduced costs, improved market stability, strengthened regulatory ability to fight fraud and increased inter-industry competition. 3/

Given the commitment of CalPERS to the competitiveness of American corporations and the capital markets for such corporations, we believe the Administration's legislative proposal provides a thoughtful and constructive starting point, balancing in part a number of the divergent views that have been expressed regarding certain of these issues. CalPERS urges consideration of the proposal, not from the standpoint of personalities or regulatory gamesmanship, but in light of the need for American capital markets to remain competitive on a global basis and in light of the handicap that regulatory and market fragmentation creates for our attempts to remain competitive. We also believe it important that all investors in our markets be assured that Congress and regulators have the tools to maintain a safe and orderly marketplace. As Dr. Gramm recently stated to this Subcommittee, "We must address the real issues the markets face in meeting the economic needs of market

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3/ Testimony of Richard C. Breeden, Chairman of the SEC, Before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, United States House of Representatives, May 24, 1990.

participants, in maintaining customer confidence, and in meeting the competitive challenge from abroad." 4/

As to the need to remain competitive, Dr. Gramm queries rhetorically, "If the CFTC had not been a separate independent agency . . ., would we have seen the growth in product that has made the United States the financial futures and options center in the world?" 5/ CalPERS agrees with Dr. Gramm that competing regulators can provide benefits to an economic system. However, CalPERS is concerned that internal domestic competition is now fostering a Balkanization in our markets that in the aggregate is counterproductive and has exposed us unnecessarily to significant inefficiencies. This in turn has led to reduced competitiveness with the real innovating force in the markets -- international competition. As noted earlier, the declining share of the American capital markets in relation to the global marketplace underscores our concern that the American capital markets are losing the international competition.

CalPERS believes that in order for the United States' capital markets to continue to be an attractive alternative in the global economy, innovation and creativity must be supported by an effective regulatory structure. The current jurisdictional dispute between the SEC and the CFTC over regulation of stock index products demonstrates a regulatory fragmentation within a singular economic system that creates unnecessary complexities and inefficiencies for that system. The dispute over regulation of stock index products, like the dispute over regulation of futures on government securities in the mid-1970s, stifles creativity and innovation in the American capital markets. The dispute prevents the free-market system from accurately judging the value of such new products as stock index participations because regulation burdens the product with years of litigation and other substantial costs.

Regulatory fragmentation such as that which impeded stock index participations must be eliminated in favor of efficiency and effectiveness, or, as Mr. Breeden pointed out in his May 24, 1990 testimony, those firms that are in a position to do so, will take their non-traditional products to overseas markets. Those who cannot access overseas markets will simply

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4/ Statement of Dr. Wendy L. Gramm, Chairman of the CFTC, before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs of the United States Senate, March 29, 1990.

5/ Id.

be unable to introduce new products because of the expensive and inefficient system that currently exists in the United States. Clearly, this is not the desired result. In this regard, we note Mr. Breeden's point that issuers in Japan, Germany, France, England and other global markets do not have to wait years or pay the enormous costs to wade through a confusing and fragmented regulatory structure.

Divided regulatory responsibility over similar products appears to result in additional inefficiency, confusion, and fragmentation. For example, both the SEC and the CFTC agree that margin requirements on all securities and futures products must be carefully monitored. However, rather than having a single federal regulatory oversight of margin requirements, we continue to have two separate regulatory bodies regulating margin requirements over similar, but competing products. On October 13, 1989, regulation of margin requirements for options on financial instruments purchased on the Chicago Board of Options Exchange was (and continues to be) under different jurisdiction than regulation of margin requirements for futures on such products purchased on the Chicago Mercantile Exchange. Although these products are intrinsically linked to the same market, there is no harmony in monitoring margin levels. Because regulation of margin requirements is in part based upon competition among domestic exchanges, the protective value of regulation over margin is diminished. If there were a singular federal authority regulating margin requirements, competition among exchanges would be based on products, service and other competitive factors, but not on a factor such as margin requirements which should function in support of more fundamental economic protections.

CalPERS does not suggest that all regulation in America should come from a single source. However, as the debate concerning regulation of stock index products and margin requirements demonstrates, regulatory fragmentation with respect to any particular product or industry can be counterproductive. Moreover, regulatory fragmentation can lead to market fragmentation. As Mr. Breeden noted in his March 29, 1989 testimony before this Subcommittee, the need for compliance with the requirements of both the SEC and the CFTC can interfere with the efficient provision of services to investors. The current system creates a disincentive for firms to trade products that involve both SEC and CFTC jurisdiction. A firm that trades stock index options, but not stock index futures, cannot advise a client effectively about the relative benefits of the alternative investments. Thus, as Mr. Breeden has also stated, "[T]he artificial distinctions between regulation of the stock and stock index futures markets increase the industry's costs while reducing its ability to respond to investor needs." 6/

It is with these concerns in mind that CalPERS is asking the United States Congress to use the Administration's proposal as the basis for rennovation of our regulatory system to ensure competitiveness of the U.S. capital markets and the companies they serve. CalPERS believes that our capital markets must promote competition and provide innovation but at the same time instill confidence through effective and efficient regulation. As international markets continue to develop, regulatory fragmentation in America, manifested by overlapping jurisdiction and legal and regulatory complexity, is driving issuers and investors away from our capital markets. This regulatory fragmentation is also fostering a fragmentation in our markets that has reduced their efficiencies and thereby weakened their competitiveness. We urge the Congress to consider with deliberate dispatch proposals such as the Capital Markets Competition, Stability, and Fairness Act of 1990 in order to eliminate unnecessary regulatory fragmentation and to reinvigorate the U.S. capital markets with both effectiveness and safety so as to restore such markets to their preeminent position in the global securities market.

CalPERS takes seriously its position as a shareholder in America. It takes seriously the responsibility it has to its beneficiaries to contribute to improvements in our capital markets that enhance the value of the capital the CalPERS holds for those beneficiaries. We appreciate the opportunity to appear before this Subcommittee and look forward to working with its members in the years ahead on these and other issues that affect the nation and our economy.

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6/ Remarks of Richard C. Breeden, Chairman of the SEC, before the Mid-America Committee, May 1990.

Senator HEINZ. Mr. Kirby.

STATEMENT OF ROBERT G. KIRBY, CHAIRMAN, CAPITAL GUARDIAN TRUST CO., LOS ANGELES, CA

Mr. KIRBY. Thank you.

I guess my principal qualification for being here today, if I have one, is that I had the privilege to serve on the Presidential Task Force with Secretary Brady and about 42 other hard-working souls that spent some 60 days in late 1987 trying to determine what happened, what the risks were of something like that happening again and what fixes were needed, if indeed fixes were needed.

I might underscore that this was an incredibly talented, industrious and dedicated group of people drawn from the investment business from the leading law firms and from a variety of colleges and universities, and I would guess they spent some place between 10,000 and 15,000 hours on this project. So if you cost that out at about $200 an hour from those souls, that is about a $3 million report. I'm sorry it wasn't evaluated that way after it was published. I think a variety of seamy novels sold more copies.

To put forth my posture here as a speaker, I represent an organization called the Capital Group in Los Angeles. I am chairman of Capital Guardian Trust Co., a subsidiary that manages about $22 billion worth of corporate pension funds. Our sister company, Mutual Fund Management Co., manages about $30 billion worth of mutual funds, and I will say of that $50-odd billion we have never had a transaction in the futures markets in Chicago. That is not to say that they don't serve a useful purpose, but there are some long-term investors who do not find that a useful alternative to an investor with a long-term time horizon.

I frankly kind of almost roll over and faint when people keep telling me there is a relationship between commodity futures and securities futures. I submit there is none of all.

I'm kind of shocked that the Farm Bureau poses moving securities futures to the SEC because I am rather positive if you took a survey of the members of the Farm Bureau and asked them could you please explain to me how major market index futures affects your ability to earn a livelihood, the farmer would say you must have just arrived from Mars and never heard of either one.

And if you went to the market-makers or floor members of the CME or the CBOE and asked them to identify or distinguish a bushel of soybeans versus a barrel of loose lard, they would be right about half the time.

There is nothing, as I see it, that relates between one of these and the other, and why the paranoia in Chicago, I do not know because the futures markets will remain there. The SEC, if they took over supervision, they are suddenly not going to raise the margin to 50 percent. I doubt if they would do anything except study their new responsibilities for a while and decide what they had to do. The markets remain active, they will remain there, and there will be a great deal of local responsibility, as there should be, but I do not see the threat.

Perhaps I'm unique among your testifiers today I guess in that I have no interest plus or minus in the financial health of the New

York Stock Exchange, the American Stock Exchange, the CBOE, and the CME. In fact, in the mutual fund business the chaos the Octobers of the last couple of years have really been good for us, but they have terrified individual investors about investing in individual American companies, and to the extent Americans have been willing to invest in common stocks, they have invested in mutual funds and that I suspect has helped us out.

I am here because I am really terrified of the potential consequences of the third crash, if and when it comes, and what the impact of that is going to be on whatever the residual respect and confidence individual Americans have in our capital markets. I think the risks of that happening are substantial and they are really terrifying.

I would like to kind of conclude on focusing on one thing that we haven't talked about, which is circuit breakers. To me circuit breakers are absolutely critical to limit the risk of a third disaster. Circuit breakers don't stop the market from going down if it's going down or going up if it's going up, but they allow brief time out, perhaps 10 or 15 minutes, to allow informed investors to make investment decisions.

I'm sure anybody here who was running money on October 19 who tried to be a buyer in that market quickly left because you had no idea at what price your orders were going to be executed. You executed a few and you found they were 20 percent higher or 20 percent lower and you said I'm running somebody else's money. I can't work in this market, and if there had just been a time out for supply demand information and for price indications to come out, there would have been a whole hord of real live, long-term investors working in that market who weren't able to participate.

Unless we create a single regulatory point that can determine harmonious margins and that can determine a sensible series of circuit breakers that operate across both cash and derivators, we are going to run into the third crash, and I am scared witless about it and I urge the passage of this legislation, and I sincerely believe it's not going to impact the prosperity of the futures markets in Chicago at all.

Senator Dodd. Thank you very much, Mr. Kirby.

[The complete prepared statement of Robert Kirby follows:]

Robert G. Kirby, Chairman
Capital Guardian Trust Company
Summary of Testimony

UNITED STATES SENATE SUBCOMMITTEE ON SECURITIES HEARING
Wednesday, July 11, 1990

It seems to me that the case supporting a single Federal regulator for both the cash markets for securities and derivative instruments does not require a long or a complicated statement. There is no alternative if we wish to provide orderly securities markets in which the investing public can have faith.

In late 1987 over 40 members of a Presidential Task Force spent an intensive 60 days investigating the terrifying market gyrations of October 16th through 20th. This was a diversified group of talented, experienced and dedicated people from all aspects of the investment business and from academia. Their first and most important conclusion reached was that the cash market and the futures market are one market. Buying or selling pressure in either market is instantly transmitted to the other. If regulation is required to provide fair, equal access to users of the exchanges and to protect them from unfair practices on the part of "insiders", then this regulation must be coordinated between cash and futures, and must come from one regulator.

In the last 30 months, our securities markets have had two near "meltdowns". No one knows how close we came to disaster or how calamitous the consequences would have been. These near misses are linked to the rapid growth of computer-driven trading strategies by investors and the development of high volume, computer-based order transfer systems by the exchanges in response to this new demand. Many of these new strategies involve arbitrage orders that are "price sensitive". Never before have our markets had to cope with waves of big volume buy or sell orders that must be executed at the best price available ... no matter what that price is.

The Task Force concluded that a protection our markets need to cope with these new forces is a system of circuit breakers or "time outs". Such circuit breakers are needed to allow information dissemination during chaotic trading conditions when most investors do not have access to enough real time data to participate. It is absolutely clear that circuit breakers must be applied harmoniously to both the cash and the futures markets and must come from a single regulator.

Our securities markets may be in several geographical locations but they are one market. Rules must be put forth on margin requirements, capital requirements for dealers, qualifications for dealers and floor brokers clearing mechanisms and a variety of other factors. All these rules should come from a single regulator.

For the better part of a century, until 1975(?) the Chicago markets dealt with commodities and the New York markets with securities. The former was regulated by the CFTC under legislation created by congressional committees focused on and expert in agriculture. The SEC regulated the New York markets through congressional legislation from banking and finance experts. It is dangerous in the extreme to allow this separation to continue now that large and active futures markets have developed.

The SEC and the CFTC not only fail to cooperate and work together for the public good; they actually engage in counter productive activities based on an old fashioned "turf war". The SEC may not be everyone's first choice as the single regulator, but obviously it is a much more logical choice than the CFTC.

The Task Force recommended The Federal Reserve as the single regulator of securities and derivatives markets. This would be a good choice. However, the FED does not want the responsibility, and time is of the essence. I am most concerned that our luck (and that is probably what saved us) could run out in the next computer-based onslaught on our securities markets, and we will find out what "meltdown" really means.

Part of the original reason for changes in the rules on margin requirements for security purchases and sales following the crash of 1929 involved the concept of social responsibility. The very low margin requirement of the late 1920s permitted professional and public speculation to rise to unprecidented levels. Margin requirements should be used to serve the social purposes today. However, if margin rates are set for the cash markets by one body and for the futures market by another, the result can be chaotic at best and very destructive at worst.

Over the past three years, activity in the futures market has frequently involved dollar volumes two times and more over activity in the cash markets. There is no doubt in my mind that this relationship is a good measure of the level of speculation. When the value of futures actively exceeded the value of cash market activity by historically high levels during the first nine months of 1987, the CFTC took no action whatever to discourage a growing level of public and professional speculation.

We know that there is a difference between "margin" in the cash markets and in the futures markets. In the former, margin is a down payment on a purchase. In the latter, margin is a fidelity bond to insure future performance on the agreed futures contract. However, the fact is that most of the time in recent years, a user of an S&P futures contact has been able to control close to $150,000 in common stock with collateral or a cash deposit of less than $10,000. This is an open invitation to speculate during periods of public euphoria. With two regulators, each having a proprietary feeling about its own markets, neither is likely to do anything to reduce the attraction of one market in relation to the other. The only possible way to use changes in margin to moderate booms and busts due to excessive speculation is to have a single regulatory authority.

Every arguement I have read (and there have been many) for maintaining CFTC regulation of the futures and options markets has been largely self-serving and competely ignores the welfare of the investing public.

My organization manages some $20 billion primarily in global equity portfolios. We have no interest, plus or minus, in the prosperity of the NYSE of the Chicago futures markets. We are only interested in fair, orderly securities markets with reasonable liquidity in New York, London, Tokyo and elsewhere. Our business is bound to be effected adversely by any ongoing decline in the public's confidence in the world's major capital markets.

Our clients are long term investors who believe greater gains will be made through committing capital to sound business enterprises on an ongoing basis, than by attempting to capitalize on short term fluctuations in the market and individual stocks. Despite a continuing study of the use of futures and option in the managing of clients's portfolios, we have never found evidence that derivatives are likely to produce better rates of return. We have never used futures or options and are unlikely to do so in the future.

Senator Dodd. Mr. Loeb.

STATEMENT OF THOMAS F. LOEB, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MELLON CAPITAL MANAGEMENT CORP., SAN FRANCISCO, CA

Mr. Loeb. Thank you, Mr. Chairman.

I appreciate the opportunity to express my views on the important issues raised by your committee. As chief executive of an investment management firm responsible for the management of $28 billion in corporate and public pension plan assets, my views are strongly influenced by our experience in global investment management and trading.

American pension plans are increasingly committing assets to equity investments worldwide. Greenwich Associates places the level of international equity investment at $68 billion of U.S. tax exempt equity funds they surveyed.

Recent estimates by others reveal a growth rate in these investments of 18 percent per year over the past 5 years. The trend toward reducing risk through global investing is far more pervasive than even these figures reveal I believe.

This leads me to important implications for the structure and regulation of equity securities and derivatives here at home.

First, you can expect institutional asset managers, many of whom have substantial experience in equity derivative trading and equity trading in non-United States equity markets to seek the lowest transaction costs for their clients. Whether considering individual stocks or derivative instruments, whether United States or foreign, they will search for the market location which provides the greatest liquidity.

In other words, they will seek the lowest total cost in terms of commissions, taxes, market impact and margin requirements. If a U.S. investment manager desires broad equity exposure, he can often purchase the individual stocks of America's largest blue chip corporations in London or Tokyo at lower cost than at the New York Stock Exchange.

One might easily envision the day when the regulatory approval a U.S. investment manager desiring broad equity exposure may be able to purchase S&P 500 index futures at lower cost in Tokyo than anywhere in the United States.

In order to maintain the competitive standing and quality of our securities market, I believe that a single authority should regulate stocks, stock options, stock index futures and options on stock index futures. This appears to be the best approach to rationalize the increasingly complex interaction in equity and equity derivative trading.

Certainly a single Federal agency could best facilitate the alignment of equity securities and derivative settlement points to avoid the current cash flow gaps so that the clearinghouse mechanism can perform effectively.

In addition, a single authority can implement clearinghouse centralization for all equity securities and derivatives so that the data crucial to the calculation of sophisiticated cross-margining requirements can be obtained.

A unified authority would also be preferable in regulating U.S. investment in foreign equity securities and derivative instruments as well as directing U.S. negotiations with other governments regarding global equity market regulation.

Finally, potential abuses, such as those inherent in stock index futures trading, specifically intermarket front running, can be better controlled by one single enforcement agency.

As I stated in the House of Representatives' hearing on program trading in July 1987, prior to the stock market break, various rapidly executed trading strategies have been associated with market volatility. It is important for a single Federal agency to be able to recognize and investigate market destabilizing strategies and place them under public scrutiny.

Furthermore, I believe that from time to time the front running of New York Stock Exchange trades with S&P 500 stock index futures transactions is recognizable and deserves to be investigated.

I believe that a single market regulator could take action far more quickly to control such behavior. In order to attain the quality and integrity in American capital markets that we all desire, a unified Federal authority must have the proper data, the analytical power to evaluate, the power to investigate questionable behavior and the ability to respond in a timely manner.

Because of its long standing experience in enforcement and its credibility as a powerful Federal agency worldwide, the SEC would likely be the best selection for this unified role.

Academic studies to date show no demonstrative relationship between the level or changes in the level of margin requirements and subsequent market volatility. However, there may be risks in maintaining an inconsistent system of oversight controls.

So long as a single Federal authority oversees a risk-based margin setting process across all securities and derivative markets and can act under emergency circumstances, the current decentralized exchange margin setting process appears to serve well.

Because of the complexity of interaction among all broadly traded securities and derivative markets and the implication of margining for the credit worthiness of our financial system, I believe that the Federal Reserve should be the appropriate oversight authority for the margin setting system.

While changes in margin requirements have not been found to be associated with subsequent market volatility, they do have a dramatic effect on market liquidity and the cost of trading.

Certainly to the extent that foreign equity mechanisms must be accessed to provide the needed liquidty, U.S. markets will lose their importance. To the extent that investors are unable to have access to the liquidity they require, an increase in the cost of equity capital for US corporations will undoubtedly occur.

Thank you.

Senator Dodd. Thank you.

[The complete prepared statement of Thomas Loeb follows:]

Statement Before The U.S. Senate
Committee on Banking, Housing, and Urban Affairs

by

Thomas F. Loeb
President and Chief Executive Officer
Mellon Capital Management Corporation

July 11, 1990

Mr. Chairman, I appreciate the opportunity to express my views on the important issues raised by your Committee.

As Chief Executive of an investment management firm responsible for the management of $28 billion in corporate and public pension plan assets, my views are strongly influenced by our experience in global investment management and trading.

American pension plan sponsors are increasingly committing assets to equity investments worldwide. Greenwich Associates places the level of international equity investment at $68 billion of the $850 billion of U.S. tax exempt equity funds they survey. Recent estimates by others reveal a growth rate in these investments of 18% per year over the past five years. The trend toward reducing risk through global investing is far more pervasive than even these figures reveal. This leads to important implications for the structure and regulation of equity securities and derivatives here at home.

First, you can expect institutional asset managers, many of whom have substantial experience in equity and equity derivative trading in non-U.S. markets, to seek the lowest transaction costs for their clients. Whether considering individual stocks or derivative instruments, whether U.S. or foreign, they will search for the market location which provides the greatest liquidity. In other words, they will seek the lowest total cost in terms of commissions, taxes, market impact, and margin requirements. If a U.S. investment manager desires broad equity exposure, he can often purchase the individual stocks of America's largest blue chip corporations in London or Tokyo at lower cost than at the New York Stock Exchange. One might easily envision the day when, with regulatory approval, a U.S. investment manager desiring broad equity exposure, may be able to purchase S&P 500 Stock Index Futures at lower cost in Tokyo than anywhere in the United States.

In order to maintain the competitive standing and quality of our securities markets, I believe that a single authority should regulate stocks, stock options, stock index futures, and options on stock index futures. This appears to be the best approach to rationalizing the increasingly complex interaction in equity and equity derivative trading. Certainly, a single federal agency could best facilitate the alignment of equity securities and derivative settlement points to avoid the current cashflow gaps so that the clearinghouse mechanism can perform effectively. In addition, a single authority can implement clearinghouse centralization for all equity securities and derivatives so that the data, crucial to the calculation of more sophisticated cross-margining requirements, can be obtained. A unified authority would also be preferable in regulating U.S. investment in foreign equity securities and derivative instruments as well as directing U.S. negotiations with other governments regarding global equity market regulation. Finally, possible potential abuses such as those inherent in stock index futures trading, specifically "inter-market frontrunning", can be better controlled by a single enforcement agency.

As I stated in a House of Representatives hearing on Program Trading in July of 1987, prior to the stock market break, various rapidly executed trading strategies have been associated with market volatility. It is important for a single federal agency to be able to recognize and investigate market destabilizing strategies and place them under public scrutiny. Furthermore, I believe that from time to time the frontrunning of New York Stock Exchange trades with S&P 500 Stock Index Futures transactions is recognizable and deserves to be investigated. I believe that a single market regulator could take action far more quickly to control such behavior. In order to attain the quality and integrity in American capital markets that we all desire, a unified federal authority must have the proper trade data, the analytical power to evaluate, the power to investigate questionable behavior, and the ability to respond in a timely manner. Because of its long experience in enforcement and its credibility as a powerful federal agency worldwide, the SEC would likely be the best selection for this unified role.

Academic studies to date show no demonstrative relationship between the level or changes in the level of margin requirements and subsequent market volatility. However, there may be risk in maintaining an inconsistent system of oversight controls. So long as a single federal authority oversees a risk-based, margin setting process across all securities and derivative markets, and can act under emergency circumstances, the current decentralized Exchange margin setting process appears to serve well. Because of the complexity of interaction among all broadly traded securities and derivative markets and the implications of margining for the credit worthiness of our financial system, I believe that the Federal Reserve should be the appropriate oversight authority for the margin setting system.

While changes in margin requirements have not been found to be associated with subsequent market volatility, they have a dramatic effect on market liquidity and the cost of trading. Certainly, to the extent that foreign equity market mechanisms must be accessed to provide the needed liquidity, U.S. markets will lose their importance. To the extent that investors are unable to have access to the liquidity they require, an increase in the cost of equity capital for U.S. coporations will undoubtedly occur.

Senator DODD. Mr. Schwab.

STATEMENT OF CHARLES R. SCHWAB, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHARLES SCHWAB & CO., SAN FRANCISCO, CA

Mr. SCHWAB. Thank you, Mr. Chairman.

I would like to thank you, Mr. Chairman, for inviting me to present my views on this very vital legislation which will consolidate stocks and index futures under the Securities and Exchange Commission.

I am confident that as you examine the weight of evidence you will conclude that this bill is a vital step in restoring liquidity and investors' confidence in the U.S. stock market.

I do use the term "restore" advisedly. We are presented today with an alarming spectacle of the stock market being driven by another market, the futures market, and that is entirely outside the jurisdiction of course of the SEC. That is all the more incongruous when you consider the futures market is only a tiny fraction, a very tiny fraction of the stock market in size.

Equities traded on the Nation's stock exchanges now currently have a market value of about $3 trillion—$3 trillion. In contrast, the money actually invested in stock future as opposed to their leverage market value of those investments is only about $1 billion. That is less than one-tenth of 1 percent of the value of stocks. It's a very small market indeed.

And the number of futures index traders is minuscule in comparison with the some 40 million investors in the stock market. My guess is there is something less than 20,000 traders in financial futures, a very small market vis-a-vis the 40 million people we speak about.

There is a spreading realization that this $1 billion tail is wagging the $3 trillion of household investments. This has led to a great credibility crisis. It has led it into the stock market, and when credibility crumbles, we all know liquidity is not very far behind that.

Already huge numbers of investors have reacted. They have reacted to this very irrational situation in a very rational way. They have headed for the exits. Since 1987 we estimate that 25 percent of the equity type investors have withdrawn from the markets. Moreover, one third of the individuals who continue to participate in the stock market buy less often and in smaller amounts.

Individual investors believe that what happened in October 1987 and again in 1989 is likely to happen again. They feel helpless, and at any time a futures backwash can create havoc with their stock portfolios and their retirement savings.

This is a consistent message that I have gotten over the last three nonths in surveys. I have had meetings with many of our investors in places not just in New York or in California, but in Minneapolis, Milwaukee, Kansas City, Indianapolis, Seattle, Raleigh and so forth. We have 115 branches, and wherever I go the message is very consistent.

There contacts obviously are important, but we also have continuous surveys among our customers. We have 1.4 million customers in the United States, and they indicate that most individual investors feel that the current system of regulation is flawed.

Our most recent survey said that 70 percent of the investors said that they would feel more confident about participating in the market if the destructive aspects of program trading, particularly index arbitrage, was brought under control, and these investors are almost unanimous in saying that the best way to achieve this goal is to consolidate the regulation of all stock related instruments under a single agency. To them such a move just makes common sense, and if something looks like a security and smells like a security, it should be regulated like a security and not like a commodity.

Stock index futures, stock options and stock are really one big market. One seqment cannot be regulated without regulating the other, and when you consider the relative size of these segments, the evidence seems overwhelming that the SEC is the proper agency to exercise authority over the integrated market.

If such authority is not consolidated under the SEC, I feel that the interest of the vast majority of American investors will continue to be held hostage to a very small group, very well organized and very well armed band of speculators and sophisticated traders who are interested only in the very short-term gains.

Individual investors are tired of being terrorized in this way. They expect Congress to establish a proper balance between the rights of the many and the self-interest of the few.

No Member of Congress can more directly benefit tens of millions of Americans and more surely protect our Nation's financial strength I think then by supporting this very bill.

Thank you, Mr. Chairman.

[The complete prepared statement of Charles Schwab follows:]

Charles Schwab
America's Largest Discount Broker

Charles R. Schwab
Chairman of the Board

The Schwab Building
101 Montgomery Street
San Francisco, California 94104

(415) 627-7000

TESTIMONY OF

CHARLES R. SCHWAB
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
THE CHARLES SCHWAB CORPORATION

BEFORE THE

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

ON THE

CAPITAL MARKETS COMPETITION, STABILITY,
AND FAIRNESS ACT OF 1990

WASHINGTON, D.C.

JULY 11, 1990

Testimony of Charles R. Schwab

Mr. Chairman, I'd like to thank you for inviting me to present my views on this vital legislation, which would consolidate regulation of the stock and stock index futures markets under the Securities and Exchange Commission. I am confident that as you examine the weight of the evidence, you will conclude that this bill is a vital first step in restoring liquidity and investor confidence in the U.S. stock market.

I use the term "restore" advisedly. We are presented today with the alarming spectacle of the stock market being driven by another market -- the futures market -- that is entirely outside the jurisdiction of the SEC.

That's all the more incongruous when you consider that the futures market is only a tiny fraction of the stock market's size. Equities traded on the nation's stock exchanges currently have a market value of over $3 trillion.

In contrast, the money actually invested in stock market futures -- as opposed to the leveraged market value those investments represent -- is only about $1 billion. That's less than 1/10 of 1% of the value of stocks. And the number of futures index traders is miniscule in comparison with some 40 million-plus investors in the stock market.

The spreading realization that a $1 billion tail is wagging a $3 trillion dog has led to a credibility crisis in the stock market. And when credibility crumbles, liquidity will not be far behind. Already, huge numbers of investors have reacted to this irrational situation in an entirely rational way. They have headed for the exits.

Since 1987, we estimate that 25% of equity-type investors have withdrawn from the market. Moreover, one-third of individuals who continue to participate in the stock market buy less often and in smaller amounts.

Individual investors believe that what happened in October 1987 and in October 1989 is likely to happen again. They feel helpless. At any time, a futures backwash can wreak havoc with their stock portfolios.

This is the message I've gotten over the past three months in meetings with numerous groups of individual investors -- not just in New York or California, but in Minneapolis, Milwaukee, Kansas City, Indianapolis, Seattle, Raleigh . . . all across the United States. These contacts -- as well as representative surveys of our 1.4 million customers -- indicate that most individual investors feel the current system of regulation is flawed.

Of those we surveyed, the majority -- 70% -- said they would feel more confident about participating in the market if the destructive aspects of program trading -- particularly, index arbitrage -- were brought under control. And these investors are almost unanimous in saying that the best way to achieve this goal is to consolidate the regulation of all stock-related instruments under one agency.

To them, such a move just makes common sense. If something looks like a security and smells like a security, it should be regulated like a security.

Stock index futures, options and securities are really one big market. One segment cannot be regulated without regulating the other. And when you consider the relative size of these segments, the evidence seems overwhelming that the SEC is the proper agency to exercise authority over this integrated market.

If such authority is not consolidated under the SEC, the interests of the vast majority of American investors will continue to be held hostage by a very small, well-organized, and well-armed band of speculators and sophisticated professional traders interested in short-term gains.

Individual investors are tired of being terrorized in this way. They expect Congress to establish a proper balance between the rights of the many and the self-interest of the few.

No member of Congress can more directly benefit tens of millions of Americans and more surely protect our nation's financial strength than by supporting this bill.

Thank you.

Senator **Dodd**. Thank you all very much for very eloquent statements and very clear statements as well.

I had hoped, as I said earlier, that we might have a bit more dynamic with some of the people who take a different point of view on this because I always think that is a more instructive hearing, but nonetheless your comments and your statements are extremely worthwhile.

Mr. Kirby, you were talking about the circuit breaker issue, and I'm wondering why that issue cannot be resolved, putting aside these other questions, where right now you run the potential risk of having a circuit breaker kick in in New York but not kick in in Chicago because they are not se coordinated. Why can't that just be done? That doesn't require 51 Senate votes and 217 House votes and a Presidential signature.

CIRCUIT BREAKERS

Mr. **Kirby**. I think when the so-called Brady group concluded they innocently and benignly thought in view of the trauma the people in Chicago and the people in New York, and I guess they are both in Washington, but anyway would get together and say we have just about blown up, the issue is so critical, let's work out a common set of circuit breakers because it stops trading, and if you are on the floor, you are the only one that has the information as to what is going on, and the guy with the quotron in LA is out of it.

If people would just do what is in the public interest, it would be a cinch to coordinate circuit breakers, but unless the two parties agree on a common set of circuit breakers, then different ones in different markets are worse than none at all, in my opinion.

Senator **Dodd**. Well, I agree with you, and I hope that message will be heard today. While we certainly bear responsibility if we don't act expeditiously to try and come up with some answers on the overall problem we are discussing here today, that particular question does not require congressional action, in my view. That is a matter that ought to be resolved between the two agencies and among the markets. At the very least that ought to be done, and in the interim it ought to be done.

Let me raise a couple of questions here, and then turn to my colleagues. Please feel free if I don't particularly direct a question to you, but you would like to make a point on this, to just jump in. This is not a formal kind of a hearing in that sense, and I think we would all appreciate your general comments.

The first note I made to myself, and it began with your comments, Mr. Atwater, and I think just about every one of you alluded to it, and that is investor confidence and what has happened over the last couple of years.

Not only are the statistics disturbing but the trend is even more alarming because it appears that the individual investors are not coming back at all. Our job, whether at the SEC, the CFTC or the Congress is to do what we can to inject confidence and stability into the capital markets.

But measuring investor confidence is very difficult to get a handle on. I'm not Leo Malamed's alter ego here, but he might say were he sitting here, Senator, what you're doing is going to have just the opposite effect. Investor confidence in stock index futures is such that we are generating a lot of activity. We are leading the world in this area. What you are doing here today is going to have just the opposite effect of what you think it is.

I wonder if anyone would care to comment on that, how we measure that and how you draw the conclusion that this particular issue has created or exacerbated the problem of investor confidence or lack of investor confidence.

VOLATILITY IN THE MARKET

Mr. SCHWAB. I would be glad to make a comment about that. On the days when we see high volatility, which now happen to be weekly, if you would analyze on the days, on those particular days when the market makes rapid moves, like in the last hour of trading, for instance, that about 40 to 50 percent of the trading in that last hour is specifically program trading.

Senator DODD. Right.

Mr. SCHWAB. You can go back through the analysis of 1987, the analysis of 1989 and so on, and clearly it's when these points of sensitivity come up, program trading exacerbates usually a benign market, or there might be some other activity that it might add to.

But at that point in time a single regulator has to say there is a circuit breaker that has to be in place to put the program trading aside and let the market reach its natural level and not exacerbate it because what program trading does is sucks up all the liquidity available, it scares and drives away all natural buyers because they simply don't know what's happening. And as long as that goes on, the public then sees the blue chips of America have high volatility, and when high volatility is present, they leave it.

Normally over the years in my experience in the market, being in the business 30 years, typically low volatility is among your blue chips and high volatility is among at least the more speculative individual stocks, and now what has happened is just the reverse. Your blue chips are very volatile and people are saying I can't even find a place in the blue chip category that is safe any more. So they leave.

Senator DODD. With respect to the volatility, I've heard people say, as they have said to me, you're a victim of your age. You're used to growing up in a time when the swings were much lower than they are, but the fact of life is that the world is changing out there, Senator, and what you see as a lot of volatility today in reltive terms isn't that volatile.

Mr. SCHWAB. Well, they see that this volatility is either manufactured or manipulated. They don't know which it is because there is not enough information that is available, but they know something is going awry, and that is what they look to us for.

Senator DODD. Mr. Bachmann.

Mr. BACHMANN. One way of looking at the problem is by looking at product mix, and our firm has a broad product mix. We do not deal in the futures market. So we are strictly in I'm going to say investment products, stocks, mutual funds, bonds, certificates of deposit and so forth, and we have seen a dramatic shift in our product mix toward risk averse products. I mean it's clear. It was starting to come back in 1989, and the impact of 1989 was devastating. It was in some ways more devastating than 1987.

In 1987, and this has been lost on a lot of people, the 2 weeks beginning October 19 buyers at Edward D. Jones & Company outnumbered sellers 10 to 1. The public, the individual investor did not run away. The individual investor saw markets. I mean they saw opportunities in the market.

I think you will find that a lot of what happened in 1987 was a professional panic and a withdrawal of liquidity in New York. It was not the American people abandoning the markets. They were in fact buyers, but upon reflection when they continued to see this volatility for no economic reason, you know, these are intelligent people and they can relate economic activity to market volatility, but when there is no economic reason for it, at some point they become I guess the best word is simply cynical.

We have clearly seen a pattern in what we regard as the long direction for the best interest. We think in the long term time has over and over again proven that the best investment for the long period is good quality equities, and we find that people are moving toward safety and they have tended to stay there because just as they were coming back it was just dashed.

Senator Dodd. Mr. Atwater.

Mr. Atwater. What frightens people is not the day-to-day volatility, but these enormous disruptions that I think all of us have talked about.

Senator Dodd. The day-to-day is what I was referring to.

Mr. Atwater. The day-to-day is nowhere near the problem that these big disruptions are, and when you have two of them, as Mr. Bachmann just indicated, it terrorizes people. So not only do you have the problem of investor confidence, but concerns as well about whether these disruptions were triggered by the futures market, which is, remember, highly leveraged. You get a series of margin calls, and that drives down the basic stock. You could begin to have settlement and liquidity problems slop over into the main stock market and really have a fundamental liquidity problem in all of our markets.

None of us has touched on that, but you could have a market meltdown, and we were darn close to having one the first time around.

Senator Dodd. That's a very good point, and frankly the rationale for having all of you here by and large was to address that very issue, the last part of your answer, and that is the whole issue of the liquidity in a sharp market downturn.

Mr. Loeb endorsed the notion of possibly the Fed filling in a responsibility here. You all heard, with the possible exception of Mr. Schwab, the debate this morning about whether or not politically we were going to be able to do exactly what the Brady proposal calls for and whether or not something like moving margin authority to the Fed would be an acceptable alternative.

Others argue you are just kidding yourself, do it right. I'm seeing one head nod affirmatively on that point, but I would be interested in a general comment from each of you quickly on that, and then turn to Senator Heinz, on giving authority to the Fed, or perhaps mandating coordination. I think that has been pretty well rejected for the reasons expressed earlier, but if you would comment on the Fed proposal as an alternative I would appreciate that.

Mr. **Schwab**. I think it's better to have it where the bill presently puts the responsibility with the SEC and then they delegate it to each of the exchanges to be administered.

The Fed has been pretty silent on the issue for the last 20 years almost now in terms of movement for the stock market, and that is really not effective management at all. I think the stock exchanges when they think their risk is high, they would raise margins high, and when they think the risk is low, which is usually in a down market, you would lower the margin requirements, and they would be the most knowledgeable group to handle that.

Mr. **Loeb**. Senator, I believe you need to understand how those margins are set. In a risk-based system, it is the relative relationship, whether they are derivative instruments, equity derivative instruments, or equities, and those relationships in terms of comparison would not be constant. There would be a structure there which would be very rational.

The big question is just how much coverage is necessary to protect the system, and it seems to me that the folks at the Fed are the likely people to be able to make that decision because they are making like kinds of decisions and are involved in systematic kinds of issues all the time.

Senator **Dodd**. Does anybody else want to comment on this?

Yes, Mr. Kirby.

Mr. **Kirby**. Well, as you may remember, the recommendation of the Brady report was the Fed, and that choice was made because of its independence, because of the extraordinary quality of the staff and because they have no budget problems, and I think Mr. Greenspan said no dice, we don't want that responsibility.

But in my written submission, you know, I kind of said I still think the Fed is the first choice, but to go from where we are now considering the SEC to appointing the Fed will make this happen next century, and I really think there is a current and real danger that we haven't tested in the finality of the impact of this new phenomenon, which is price insensitive, computer driven trading strategies that exist because of the futures market in Chicago and where there is an interaction, and where I really think on October 19, 1987, if some people hadn't been so incredulous as to override their computers, we really would have tried to go to zero in one day, and the danger, I think, is real.

Senator **Dodd**. Any further comment on that point?

Yes, Mr. Atwater.

Mr. **Atwater**. I was really going to make the same point. The Fed has said several times that they don't want the ball. The ball has got to be given to somebody and be given to them soon, and the SEC would appear to be exactly the right place to place that ball.

Senator **Dodd**. I understand that argument and I understand your point. The question is whether or not that is a practical result from what we have to go through up here. I'm just curious as to whether or not if the Fed were an alternative that were politically acceptable, is it substantively acceptable to people like yourselves, and that's my point really. I understand your point.

Senator Heinz.

Senator **Heinz**. Mr. Chairman, first I want to commend these witnesses for as a group some really extraordinary and outstanding testimony, starting with Mr. Atwater who led off and who said, among other things, on pages 2 and 3 of the market that they actually make in his pension fund probably some money off the volatility of the current system, but nonetheless he understands the flaws in the current system, notwithstanding that his pension fund manager took a little while to see the light, but nevertheless he is here today.

As I understand all of your testimony to recap it, and I do this so if anybody thinks I have misspoken on their behalf they can correct me, you're all saying that the volatility perceived by the public, particularly on days in October in odd numbered years, has created a great investor distrust or uneasiness, that that has lowered the long-term participation of many equity investors in the underlying stock market, that that has as its effect a reduction of the pool of equity capital available to corporate America represented in part by Mr. Atwater and by Mr. Mendell, and that it is a very serious problem because it puts American corporations as well as American investors at a competitive disadvantage, it causes our capital to go overseas and maybe our firms' business to go overseas.

Is that generally speaking a fair statement of all of your concerns?

When you run into such a diverse group of people all agreeing, you begin to worry, and it reminds me a little bit of what Meternick, the great German statesman who was also a great cynic, which may be what it takes to be a great statesman——

Senator **Dodd**. Or a great cynic. [Laughter.]

Senator **Heinz** [continuing]. Said when at the Congress of Vienna, he was informed of the death of the Russian delegate. His reply was yes, he is dead, but what can have been his motive. [Laughter.]

And with respect to those who oppose this, and I'm talking about the people in Chicago who have decided to testify on another occasion, I really do wonder about what is their motive because we all know them, they are Americans and they don't want this country to flounder, and it can't be good for them in the long run to have a market situation which is volatile, which discourages the underlying equity investors and will ultimately hurt the futures market in Chicago.

So I'm puzzled as to why the Merc and the others are so singlemindedly opposed to this change of regulator over 5 percent of their business.

Does anybody want to speculate about what the problem is here, because it doesn't after you peel it all the way in the final analysis make sense. We understand about turf, and we all understand that the CFTC may be the devil they know versus the devil over here they they don't, but in the final analysis it's still puzzling.

Mr. Atwater.

OPPOSITION TO JURISDICTION UNDER THE SEC

Mr. **Atwater**. Well, I think, Senator, they are primarily concerned about the camel's nose under the tent. I think they are very worried that if the stock index futures move, that the next thing you know, the wheat market and the corn market and so forth will move, and that's why I was pleased to be invited because we participate, as I said in my remarks, in both of these markets and would be absolutely opposed to moving any agricultural commodity over there.

Secretary Brady has made it exceptionally clear that he would in no way support that, but from our own agricultural people I know that is one of their major concerns.

I think a secondary concern is that these very highly leveraged markets are quite profitable and should there be times when the margin requirements go up, they might not be quite so profitable. But as you pointed out, it is a very, very small part of the total trading, and profit loss, I think, is frankly of less concern than the possibility of seeing the whole thing move over there at some point.

Senator **Heinz**. I don't know of anybody who wants to put pork bellies in the jurisdiction of either the SEC or the Banking Committee. We have got enough problems with S&L's.

Senator **Dodd**. We've got our own pork here, too. [Laughter.]

Senator **Heinz**. I'll not think about that.

Mr. **Schwab**. Senator Heinz.

Senator **Heinz**. Mr. Schwab.

Mr. **Schwab**. I would just make one comment. I think they are a little myopic. I think by bringing this jurisdiction under the SEC it's going to add credibility to the whole instrument, the financial future and the stock index futures, and it will probably bring more people into that and it might bring more public into it, who knows. Our firm might even go into it. We don't do it presently, but I think with that kind of oversight and confidence that you can get clear and good trading on the floors there without the FBI at every post [Laughter.]

That it's possible that we might go into that business.

Senator **Heinz**. Well, that brings up the question of the relative skillfulness and competence of the two agencies, the CFTC and the SEC, which was commented on, I wouldn't say with evenhandedness, but with certainly great force by Senator Eagleton earlier who described the CFTC as the pygmy regulator.

Is the CFTC incredibly flawed?

Mr. **Kirby**. I think it's entirely competent to regulate agricultural commodities. The entire history of CFTC, especially a few years ago if you talked to the people there, they knew a lot about cattle and soybeans and cotton, and it's crazy to consider that background, no matter how good the people are to take over. It seems to me they've either got to have one party or the other take over securities and derivatives, and the idea of choosing the CFTC over the SEC causes me to faint a little bit.

Senator **Heinz**. Is that the basic problem then, since they are supposed to spend 95 percent of their time and resources looking after agricultural commodities and agricultural futures that they just don't have the experience and the wherewithal and the capability to train people to really do the kind of job that should be done here?

Mr. **Loeb**. Somebody mentioned earlier that the folks in Chicago at the CFTC may have a more laissez faire attitude toward regulation than the SEC. For many years the New York Stock Exchange has had an antifront running rule banning front running. Brokers can't front run their customers' orders. It took years for the CFTC to invoke that kind of regulation and for the exchanges to invoke that kind of regulation against intermarket front running. It has been done, but it took a long time.

Senator **Heinz**. let me ask you what I suspect the $64 question is, and certainly in Chicago and for anybody who is interested in this question.

Since you all agree that the SEC should be the regulator that has jurisdiction over the derivative products, in this case index futures, and if the SEC does get that authority as proposed in the Brady bill, what changes would you as a practical matter expect to see on any of these issues? What will be different?

Mr. Bachmann.

Mr. **Bachmann**. I think there will be an enormous difference in perception, and this is what troubles me about these half-way solutions and suggestions like just merging the agencies.

If I were in agriculture, the thought of merging the agencies would be so much against the grain farming that I can't picture ever being in favor of having the agricultural side, that part becoming a part of the SEC. I just don't think it makes sense.

On the other hand, the American people are looking for a sign. They are looking for some sign that all parties recognize the seriousness of the problem and that something is really going to be done. I think that the knowledgeable people know what needs to be done, and I think that the symbolism of the action would go as far as anything to say we have taken the steps that we believe are possible to take based upon the best knowledge available to deal with the problem of artificial volatility, not economic volatility, but technological volatility in the markets.

Senator **Heinz**. We have tried symbolism on virtually everything I can think of over the years, and most recently the budget. [Laughter.]

Where we pass some numbers that are symbolic of our desire to reduce the deficit, but it just doesn't work out that way. There has got to be more to it than symbolism.

Mr. **Bachmann**. I think there is.

Senator **Heinz**. A lot of political blood is going to be spread around here, and if it's just for the sake of symbolism, I'm not sure that that's going to get a lot of people really excited and marching out on this battlefield.

Mr. **Bachmann**. No, that's not the only part. I mean basically it does change the game.

Senator **Heinz**. I hope we can do better than symbolism.

Mr. Schwab.

Mr. **Schwab**. Well, I would say that there are a number of things that they would probably do. I think one of the things, there still is an information void. We have not been able to get all of the information out of the commodity world that we would like to have to really understand all the secrets that are there.

But once that is there, I would suggest that they would probably when we get into a highly volatile period, they would install circuit breakers that would eliminate this vast and credible volatility that goes on on these given days, and they could easily do that and it would be coordinated at that point. They would stop trading in the commodity or the financial futures. That would be the first step. The second step might be to do something with a specialist. They could coordinate those activities and reduce volatility by a substantial percentage.

Senator HEINZ. I know I have exceeded my time, but I've got to ask Mr. Kirby this question because he was on the Brady Commission as I recollect.

What else would be different?

Mr. KIRBY. That's the thing that makes me so curious as to why the people in Chicago feel as paranoid as they do because I don't think very much would happen.

You would, I think, get a review of the implementation of a system of circuit breakers. You would get common requirements for floor brokers and specialists, and if you entered another period like the first half of 1987, I think you would find serious considration given to raising margin requirements in both markets.

What happened in 1987 was Chicago would not increase its margin requirements despite the fact that volume was triple and more the volume in the cash market because it was self-serving to leave them where they were, and the concept of social responsibility which went behind securities legislation reform after the crash of 1929 went out the window. Neither market would change margin requirements regardless of the degree of speculation, but with a single common regulatory point I think in an environment like the first half of 1987 you would have a much better chance of acts taken to discourage excessive speculation.

Mr. SCHWAB. Further, the uptick rules would be applied consistently. There is no uptick rule now I don't think in the futures market. So when you get a market plunging, you can continue to sell as you wish. There are no consistencies there. There is inconsistency in the front running kinds of things also, although there are ways. The legging situation allows for these inconsistencies, and so someone could apply a common thread through that and reduce the problem.

Senator HEINZ. Well, I thank you all.

Mr. Chairman, my time has more than expired.

Senator DODD. Senator Cranston.

Senator CRANSTON. Thank you very much, Senator Dodd. I thank you and the chairman of the committee for arranging these hearings on a matter that is very controversial and very complicated and very fascinating.

I regret that I haven't been able to hear all of your testimony or of the other witnesses because of other commitments, and I apologize particularly to the several Californians that are on this panel, and I'm delighted that you are here.

I do have just two questions that I would like to put to whoever chooses to answer them.

First, in many countries securities and derivative products are dealt with in one market. Do you believe the continued separate regulatory structures imposed in the United States will impair or do impair our competitiveness with other markets abroad?

Eventually one of you will decide to answer. [Laughter.]

Senator **Heinz**. They are all invoking their Fifth Amendment rights. [Laughter.]

Mr. **Schwab**. Senator Cranston, I would say by having two organizations having oversight, and inconsistent oversight, that it will be impossible for our regulatory people to coordinate the actions with the French, with the Germans and so on. So as we go forward with more internationalization of the markets, America will be singly, there will be inconsistency and we won't have things happen here where trading will go off into the other markets.

Senator **Cranston**. Any other comments on that?

Mr. **Kirby**. One of the reasons the Brady bunch chose the Fed was just because they had a history of being an internatinoal body working with foreign bankers and the realization that whatever had to happen to achieve the integrity of world market required a lot of coordination, and so to the extent that we are uncoordinated here in the regulation of our markets, I think it makes foreign markets more attractive as time goes on and nothing dramatic in the short run.

Senator **Cranston**. If Congress voted to give the SEC regulatory power over stock index futures, do you have any idea how they would proceed to carry out that mandate? Would the SEC have to invent a mini-CFTC under its own roof to supervise the five trading markets, or how would they proceed?

You're shaking your head on, Mr. Atwater.

Mr. **Atwater**. I think they could regulate it with basically the same structure they have now. There were a number of answers to the questions that Senator Heinz raised that were on the subject of coordinating various aspects between the markets.

The major problem and the major thing I believe they would do is to coordinate the margin requirements, which of course have to be different in different kinds of economic cycles. Where you get very, very low margin requirements in the derivative markets in a highly speculative time, you get the derivative markets driving what happens in the basic stock market, and that is what has caused these huge disruptions. Coordinating those margins properly is the fundamental thing that has to be done. You can then do a lot to mitigate the major disruptions that we had in the two Octobers. That would be the major issue.

Senator **Cranston**. Any other comments on that point? [No response.]

If not, I don't have any other questions at this stage. Thank you.

Senator **Dodd**. Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman.

A number of you have addressed what I believe to be one of the very serious concerns that we must address in these measures in considering what legislative action to take.

There has been, first, a great concern about the possibility of a third crash, and the fact that that really might then spill over into the general economy. But I think the problem that we have with us now is the one that a number of you have identified, and that is that it's the small investors who have left the market. I think that is bad for our international competitiveness, and I think it's bad for those small investors themselves who have been driven out of the market.

PROGRAM TRADING

I've found an interesting thing, and I'll address this first to John Bachmann. As I have talked to many of the retail brokers in Missouri from other firms and yours, after the 1987 crash and after the 1989 crash, they said flatly the problem is program trading. We've got to get rid of program trading, and they see that as the evil to which all action must be directed.

John, how do you think that establishing a single regulator or changing the framework for regulation leaving in place program trading could be sold as an adequate response to them?

Mr. BACHMANN. Well, I think that program trading is a term they see in the paper that they simply associate with excessive volatility. I mean if you were to ask a group of people to sit down and define it, you would get all sorts of answers. But what they are really responding to is a phenomenon that they experience.

It's our view that with the single regulator and with the clearing up of the ambiguities as to who is in charge and who has their hand on the lever if something has to be done, and beyond that that margins are also being regulated in a way that has been described by some others here, I think it simply clears the air. I believe that it's not the sole solution because this is a very complex problem.

But there are some solutions that have come up over and over again, that's what we're talking about now, and if we can address those issues, then I think we send a clear message to people that we are serious about their concerns and having them be part of the market.

When I said symbolism, that was a poor choice of words. I wish I had used something else, but I think that simply would be the reflection of reality, that the Congress has taken strong, positive and very tough, and we understand very difficult action to deal with a very difficult problem, and I think that would underscore the seriousness with which the Congress was dealing with the problem.

Senator BOND. Are you saying that an agency with the ability to set margins would discourage the volatility in program trading by raising margins?

Mr. BACHMANN. I think at times. I think if you look at what happened in 1987, you know we focus on the downside of the market. The market was almost out of control on the upside as well. People had this false notion that somehow portfolio insurance had inoculated their portfolios against risk and that they could get out first.

Of course I compare it to the Cardinals and the Cubs. We have our stadium right on the river, and that's a great baseball rivalry and half the fans are from Missouri and half are from Illinois, and all the Cub fans about the ninth inning start to thinking about how they are going to as soon as the last out is made, they are going to be in their cars and across the bridge.

I think that's what the people with portfolio insurance thought, was that they were all going to get across the bridge first. A few of them did, but most of them ended up in a long line.

You know, one of the things that really troubles me, and it troubled me in the testimony this morning was this trying to point the finger between New York and Chicago. I think that is missing the point.

I think the point is we have mechanisms in place which, regardless of where it starts, transmits the selling pressure out of the futures market into the cash market through portfolio insurance. So how can you blame one party or the other? That's really not the issue. The issue is that our innovation both in trading techniques and in tools available has simply outrun our ability to regulate them and we've got to bring that back into check.

Senator **Bond**. Well, John, unfortunately the way the Cardinals have been going, I don't think we are in danger of traffic jams. [Laughter.]

But I would believe, at least I would think that the lesson program trading and portfolio insurance has been learned that a free lunch is not there, and I expect that the levels of portfolio insurance are significantly reduced.

Mr. **Bachmann**. Two comments. First, there is a fight, Senator, for last place in the National League that is equally important, and the Cardinals and the Cubs are still in that struggle. [Laughter.]

Beyond that, I'm told that there are people today who do believe that portfolio insurance is back in fashion and that there are those who are still convinced that they can get there first, and that creates a complete distortion of the supply demand equation because you have such organized selling pressure with portfolio insurance, and I don't know what percentage.

Senator **Bond**. Are you going to ban portfolio insurance?

Mr. **Bachmann**. I think you have to make the cost high enough. I heard a fellow explain it.

Senator **Bond**. In other words, by raising margins?

Mr. **Bachmann**. Well, it's like fire insurance. If you price fire insurance so high, nobody can afford to insure their house against a fire. If you price it so low, the whole town burns. And I think that portfolio insurance can be priced so low, that there is such a low cost that more people have it that can afford it. It should be priced in a way that reflects the impacts on the market, and in 1987 it wasn't, and in 1989 it really wasn't and, unfortunately, the circuit breakers were there.

I recall in 1989 complete panic. Fortunately this all happened on a Friday afternoon in the last hour or so, but there was an enormous fear, and I can't imagine what it was like in the regulatory agencies, but my guess is that there was enormous scurrying around trying to come up with some kind of a solution to make sure that we didn't open Monday like we did October 19, 2 years earlier.

Mr. **Loeb**. One thing if I may.

Senator **Bond**. Go ahead.

Mr. **Loeb**. One thing to remember is that price insensitive transactions in waves moving minute to minute can occur in the stock market as well as in the futures market.

Senator **Bond**. Mr. Loeb, did I understand you? Did I get your message correctly? You said increasing the margin does impact on liquidity but not volatility?

Mr. **Loeb**. Right. I said there is no evidence——

Senator **Bond**. So you are saying that volatility is still there even if you have higher margins?

Mr. **Loeb**. I'm saying that the academic studies suggest that there is no evidence to link changes in margins with subsequent market volatility. That's an academic study.

Senator **Bond**. That blows our whole scheme then.

Mr. **Loeb**. But if you raise margins, certainly you will impact liquidity because fewer participants will be acting in the same marketplace.

Senator **Bond**. Well, that's one question, if I might extend just a second, I also wanted to address to Mr. Schwab.

You said that you found in your surveys that program trading was the real problem and people wanted to get rid of program trading. Did you say that your surveys showed that they then concluded, that the respondents to your survey said a single regulator would get rid of program trading?

Mr. **Schwab**. Well, that's their general belief.

Senator **Bond**. Is that from brokers you deal with or investors?

Mr. **Schwab**. It's from investors that we speak with. Their view is that if we have a single regulator, that they will come to the conclusion that program trading in those special moments needed to be abolished at least maybe for the day.

Senator **Bond**. That I think gets back to the other side of what we may be backing into if there is a desire to ban program trading or to run program trading out, and then I think we have to look at the international impacts of trying to get rid of program trading here.

Well, I'll just say I'm a little bit perplexed about the comments Mr. Loeb has made about the lack of impact on volatility of higher margins.

Mr. Atwater, maybe you can enlighten me, and I can go home comfortable.

Mr. **Atwater**. There have been several studies on this, Senator, and the studies are not at all clear on this subject. There is testimony that Mr. Mullins gave in the answer to Senator Dixon's questions on this subject that cite particular studies, and I can give you the reference on those later.

The issue is not average daily volatility, as I was trying to say, it is these huge disruptions. I think there is no question that margins and these major disruptions are in fact laced together. As for day-to-day volatility, there are some studies that indicate what Mr. Loeb said. There are also some other studies that say there is a correlation. But on these big disruptions, if you had higher margins, you would not have the circumstance that would create those disruptions, and that is what we have got to guard against. It's not day-to-day volatility that is discouraging the small investor. It's those big October monsters that scare them.

Mr. **Kirby**. Could I add something to that.

One of the—I had a brilliant stroke and it flew right from my mind. I could have solved the whole problem. Sorry about that.

Senator BOND. Mr. Kirby, I'll leave you my business card in case. It usually comes to me about one or two o'clock in the morning and if you'll just write it on the back of this card, I'll be happy to have it. [Laughter.]

Thank you, Mr. Chairman.

Senator DODD. John, do you have any more questions?

Senator HEINZ. No.

Senator DODD. John said it well. All of you have been remarkably eloquent in your statements, and I mean that. It's not something that I say to every panel that comes along. I think you've offered some valuable information.

I asked the second panel this morning, and I asked Tom Eagleton the same question and, Mr. Kirby, you certainly alluded to it in your statements. I would just quickly ask the rest of you to comment on this.

Now I'm not going to suggest that I misspoke in the second panel when I indicated that our failure, that is the Congress' failure to move on, if not this specific piece of legislation, something that will deal with the problem at hand here that you identified. While I believe none of you have braced the notion that in and of itself it's going to create a problem, but rather like program trading or the absence of circuit breakers can exacerbate a problem created for other reasons.

You suggested, Mr. Kirby, that there could be serious problems when and if we confront another market break of the proportions we saw either in 1987 or 1989, and I would just ask each and every one of you whether or not you agree with that or care to make any particular comment on that point on how much of a burden is on this institution to take up legislation to respond to this problem now that it has been identified as clearly as it has been from this particular group.

Mr. SCHWAB. Oh, I certainly would agree with Mr. Kirby on that. The third crash will come and I think you'll take immediate action. Hopefully you can take steps now and we won't have the third crash.

Senator DODD. But our failure to do so would place a burden.

Mr. SCHWAB. It's almost automatic.

Mr. ATWATER. Yes, I completely concur with those comments.

Mr. MENDELL. I'm also in agreement. I think the theme that has run through is you need somebody in control, and when you split control you in essence have substantially reduced control. I think putting the responsibility under one authority clearly is going to go a long way toward resolving the problem in dealing with circuit breakers and other issues involved.

Mr. BACHMANN. I said in my testimony that I believe that this will happen unless we act and act decisively. But I think what it will involve, Mr. Chairman, is a combination of the technology with an economic event.

In other words, it's not the one by itself, but it's the very volatile mixture because when you take a look at what happened in 1987, and I went around and visited with the leadership of every major firm in the following 2 weeks to assess damage, and the first thing I discovered in every case is the initial instinctive reaction, not of the regulators, but of the financial side was to withdraw credit from the market, to take it out of the specialist system and to take it out of the firms themselves, and there were terrible rumors involving the strongest and finest firms in America around the street that I'm sure some of you heard because of some initial instinctive actions that went against what stepping back and assessing it in a little bit different way might have caused to happen.

I think any time you have that sort of an ambiguity in there, you simply run that risk and you start mixing these with true economic or other kinds of political events, and I think you have an incredibly volatile mixture.

Senator DODD. Mr. Hanson.

Senator HEINZ. I agree with Mr. Kirby that Congress has to act and act now. Three years have really come and gone since the first market break and then we had 1989. We continue to have blue ribbon panels studying the issue of volatility. The New York Stock Exchange just issued their report and we have a number of groups. If for nothing else, you might save a tree from just the number of special reports being published on this topic.

Senator DODD. Mr. Kirby, do you want to address this?

Mr. KIRBY. I've kind of had my turn, but I did remember what I was going to say.

Senator DODD. Well, you saw Senator Bond leave, but I won't tell him what you said. [Laughter.]

Go ahead and tell us.

Mr. KIRBY. One thing circuit breakers do is they are to index arbitrageurs and program traders what the Orkin man is to a cockroach. If you want to reduce volatility, a system predetermined known to all circuit brekers does a great job. [Laughter].

Senator DODD. Mr. Loeb.

Mr. LOEB. I believe the unified control and unified margining is critical soon.

Senator DODD. Well, I appreaciate that.

There may be some additional questions for you by other members of the committee.

[Additional questions to be submitted by other committee members and answered for the record follows:]

THE SECRETARY OF THE TREASURY
WASHINGTON

July 6, 1990

The Honorable Christopher J. Dodd
Chairman, Securities Subcommittee
Committee on Banking, Housing, and Urban Affairs
U.S. Senate
Washington, D.C. 20510

Dear ~~Mr. Chairman~~ Chris:

Thank you for your letter inquiring about the impact on the agricultural community of the Administration's proposal, the "Capital Markets Competition, Stability and Fairness Act of 1990."

First, you have asked whether I intend the proposal to be the first step toward merging the SEC and CFTC. My answer is an emphatic no. By my reading of today's markets, the proposal is all that is needed. I think no further shifts in regulatory jurisdiction are necessary -- not Treasury bond futures to the SEC, not a full merger of the SEC and CFTC. Stock index futures are all that need to be fixed. If the proposal passes in its present form, I will oppose additional changes to the CFTC's jurisdiction.

Second, you have asked whether the CFTC would be rendered a less effective regulatory body if the proposal passes. Our proposal would minimize the effect on the CFTC, because stock index futures represent less than 10 percent of the futures volume under CFTC jurisdiction. Indeed, the CFTC will be able to concentrate its considerable expertise on the more traditional agricultural and financial futures products that have long been the core of its jurisdiction.

In fact, moving jurisdiction over stock index futures to the SEC makes it more likely the CFTC will survive as an independent regulatory agency regulating agricultural futures. If the proposal is not enacted, the CFTC runs a great risk that stock index futures will be blamed the next time there is a market collapse. There could then be great pressure to merge the CFTC and the SEC in order to get control of the markets. Bills like the Glickman-Eckart proposal to combine the two agencies may develop a momentum of their own.

Finally, you have asked what impact our proposal would have on the individual farmer and the agricultural community in general. The proposal would have no effect on the agricultural community, since stock index futures have no relation to agricultural products or agricultural futures.

I believe the proposal is essential to protect the financial system and preserve U.S. leadership in global markets.

Sincerely,

Nick

Nicholas F. Brady

A.G. Edwards & Sons, Inc.
INVESTMENTS SINCE 1887

One North Jefferson
St. Louis, Missouri 63103
(314) 289-3070

BENJAMIN F. EDWARDS III
Chairman

July 5, 1990

Senator Christopher J. Dodd
Chairman
Securities Subcommittee
Room 534 - Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Dodd:

I am Chairman of A. G. Edwards & Sons, Inc., the largest stock brokerage firm not headquartered in New York. We have 413 offices in 47 states, with 4,000 investment brokers among 8,100 total employees. We do primarily retail business, and our purpose is to act as agent for our customers.

I am sorry I shall be unable to testify before your Committee July 11, but prior travel plans that day prevent me from getting to Washington. For what it's worth, I shall comment briefly on the five questions you raised.

1. I don't believe that having a single regulator of stock and stock derivative instruments will materially affect market volatility. However, I believe such a step would be logical and seem appropriate to investors who are looking for the "level playing field." Certainly regulation should be more even-handed.

2. I believe the SEC would be the most appropriate body to perform such regulation. In addition to the obvious reason of its long experience with equities, our operations people tell me the SEC's inspectors are clearly superior to those of the CFTC and its regulated exchanges.

3. Low margin requirements allow little speculators to play big and big speculators to put up less of their money. Higher margin requirements would make less index arbitrage viable. Markets containing lots of borrowed money are riskier because sharp moves could force liquidations to meet margin calls, acts which would exacerbate the downward market move. The same would be true if one were short and the market moved up, triggering purchases to cover the short position.

The 50% margin requirement on stocks set back on January 3, 1974 by the Federal Reserve has proved prudent over a long period of time, and everyone knows what to expect. Margin changes made by the Chicago Mercantile Exchange have always been after the fact or event. If higher margins are appropriate after a devastating market drop, wouldn't they be even more appropriate before the drop? I respectfully suggest that margins on index options be set at the levels judged prudent by the Chicago Mercantile Exchange after the crash.

4. Oversight on stock index futures margins is appropriate at the federal level, and margins should be set at a level consistent with an acceptable amount of speculation and then left there.

5. I don't feel qualified to comment on needs to modify the "exclusivity clause" of the CEA, but it just doesn't seem right to me that both stocks and their futures should be traded side-by-side

I might add that a rule to prevent a firm from doing program trading both for customers and for its own account would do more good than harm. It may not be fair, but it would remove a potential for abuse and be applauded by investors throughout the land. After all, most firms voluntarily stopped program trading for their own accounts after the major market breaks in 1987 and 1989. They must have had a reason, and that reason should still exist.

Respectfully submitted,

BFE:ct

Testimony of

Frederick L. A. Grauer

Chairman, Wells Fargo Nikko Investment Advisors

before the Senate Committee on Banking, Housing and Urban Affairs

July 11, 1990

Chairman Heinz, Senator Dodd, and members of the committee:

Thank you for giving me this opportunity to represent the views of Wells Fargo Nikko Investment Advisors concerning the Administration's legislative proposal, the "Capital Markets Competition, Stability, and Fairness Act of 1990."

Wells Fargo Nikko Investment Advisors manages about $85 billion in US and international stocks, bonds and money market instruments on behalf of almost 400 institutional clients. Most of our clients are corporate and governmental savings and pension plans, representing collectively the retirement benefits of tens of millions of American workers. Components of our business are regulated by the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Department of Labor, other federal and state agencies, and various self-regulatory organizations. So we are vitally interested in the competitiveness, stability and fairness of our markets, and in how they are regulated.

We agree with the concepts underlying the administration's proposed legislation. First, we agree that today's US equity markets have been vastly and fundamentally transformed by the advent of stock index futures and options. We believe this transformation has been positive on balance, enhancing opportunities for all American investors, and increasing the global competitiveness of US markets.

Second, we agree that financial safeguards and economies of scale may possibly be realized by rationalizing the regulation of these transformed markets under the jurisdiction of a single regulator. We believe that the jurisdictional war waged between the SEC and CFTC since 1975 has been counterproductive, and the time has come to resolve it.

We do not differ with the Administration in concept, but we disagree in method. Specifically, we firmly believe that empowering the SEC to regulate stock index futures would be a mistake. For this reason we must urge that this committee reject the Administration's proposed legislation.

We are more in sympathy with Treasury Secretary Nicholas Brady's earlier views on this subject, as expressed in his Report of the Presidential Task Force on Market Mechanisms. "Extending SEC authority to stock index futures might require an investment in expertise necessary to regulate complex instruments new to its regulatory purview. ...Moreoever, the SEC's experience and expertise is focused primarily on regulating intramarket activities, not on rationalizing the interactions among markets."

SEC Commissioner Edward H. Fleischman agrees. Quoted in the New York Times, Commissioner Fleischman has said, "I wonder whether the SEC would be able to regulate the futures markets as effectively as the CFTC does. You tell me what we would do differently. I would venture to say, nothing. ...We really don't understand those markets, it is a different world."

Indeed, there is no evidence that the SEC grasps either the unique risks or the unique benefits of stock index futures, or a complex marketplace in which stocks and futures can interact. Like the mythological Procrustes who chopped off the legs of house-guests too tall to fit into his bed, the SEC has indicated it intends to regulate stock index futures as though they were securities, by such means as the wholesale and entirely unwarranted increase of margin requirements.

SEC Chairman Richard Breeden's call for higher futures margins to control volatility exhibits a fundamental misunderstanding of the role of margins in futures markets. The overwhelming conclusion of a large body of academic research into this matter has concluded that changing margin levels is ineffective in controlling volatility. Furthermore, raising margins threatens the economic usefulness of futures markets --and indeed their very viability-- by increasing the costs of using them.

Measures such as this may well serve the anti-competitive interests that would relish the destruction of stock index futures, but, let me assure you, they do not serve the global competitiveness of US markets. Competitiveness is the product of innovation. Relatively few of the last decade's important innovations were created under the jurisdiction of the SEC.

The stability of US markets would be equally ill-served by this proposal. The SEC has shown no evidence of leadership in the creation of innovative and robust trading and clearing mechanisms capable of handling volatile market conditions. Indeed, during the several episodes of market turbulence of the late 1980s, trading and clearing systems regulated by the SEC performed far worse than those under the jurisdiction of other regulators. Following the market crash of October 19, 1987, the New York Stock Exchange's trading system virtually collapsed. On the Chicago Board Options Exchange, trading in S&P 100 Index option contracts was so problematic that members had to pay a special assessment to fund settlements with disgruntled investors. Both these melt-downs were the result of antiquated practices preserved under the supervision of the SEC.

Finally, the fairness of US markets would also be ill-served by this proposal. There is truth behind the public criticism of the CFTC's inadequate surveillance and enforcement capabilities. But we should have no illusions that the SEC will do any better, however, if only we note the recent insider trading scandals.

We agree that US markets must be made more competitive, stable, and fair. To accomplish this, the jurisdictional war between the SEC and the CFTC must end. But this war has left both combatants bloodied and dishonoured. At this point, empowering the SEC to regulate stock index futures would be as great a mistake as empowering the CFTC to regulate stocks.

We urge that the Administration's proposed legislation be rejected. Let alternate legislation mandate the in-depth research required to formulate truly innovative regulatory structures that will be worthy of the innovation that has transformed our markets.

Again, I thank you for the opportunity to testify.

THE SEC/CFTC JURISDICTION AND MARGIN

THURSDAY, JULY 12, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, pursuant to notice, at 2:20 p.m., in room SD-538, of the Dirksen Senate Office Building, Senator Dodd, presiding.

Present: Senators Riegle, Garn, Dodd, Heinz, Dixon, D'Amato, Graham, Roth, Bond, and Sarbanes.

Also present: Senator Paul Simon.

Senator DODD. Let me turn to Chairman Riegle if I can, right off the bat.

The CHAIRMAN. Very good.

Senator DODD. We apologize, by the way, Mr. Secretary. We have been tied up in the Budget Committee. We had four votes in the Budget Committee and both Senator Riegle and I had to stay there. There are no proxies allowed in the Budget Committee. So you have to be there for the votes, and they were narrow votes decided by a one or two vote margin. So we apologize for being late.

The CHAIRMAN. Mr. Secretary, let me welcome you before the committee. This is an important occasion. As you know, we had a very important hearing yesterday morning and afternoon. So we are very much interested in your views.

We are convening this hearing at the full committee level because of the importance of the issues that are involved here, but the Securities Subcommittee is going to be leading the effort to try to develop a workable answer here, hopefully on a bipartisan basis between the Congress and the administration, and Senator Dodd, who is chairman of that subcommittee, along with Senator Heinz, the ranking member will be the one that leads that effort.

So while we are convening this at the full committe level, Senator Dodd will be running the hearing today in that capacity and for that purpose.

[Opening statement of Chairman Riegle follows:]

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. Today we continue our consideration of "The Capital Markets Competition, Stability and Fairness Act of 1990." Yesterday, we heard from Tom Eagleton, our former colleague, who vigorously and enthusiastically advocated enactment of this legislation. Other witnesses, including representatives of the National Association of Securities Dealers, the American Stock Exchange, the Ad Hoc Coalition for Intermarket Coordination, also urged its adoption. A third panel of witnesses consisting of market participants and brokerage firms that serve individual investors, argued that enactment of The Capital Markets Competition, Stability and Fairness Act was necessary to increase investor confidence in our financial markets.

This afternoon, we will hear from Treasury Secretary Brady. As we all know, Secretary Brady led the Presidential Task Force on Market Mechanisms, which issued a comprehensive report on the causes and effects of the 1987 market crash. Since that time, he has remained an active participant in discussions concerning the proper structure of this Nation's financial markets. In the current debate, Secretary Brady has argued that the current division of authority between the SEC and the CFTC leads to disjointed regulation of the markets governing stocks, stock options and stock index futures, which, he argues, are one market.

We welcome Secretary Brady here today, and look forward to discussing his views on the proper regulation of the financial markets.

Senator DODD. Thank you, Chairman Riegle.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. Mr. Secretary, let me just make an opening comment if I can, first of all, to echo Senator Riegle's comments. We had what I thought was a very good day yesterday. It was a day where we heard exclusively from those who support the administration's proposal on this matter.

We had earlier intended to have a mixture of both people from those who opposed as well as supported, but there was a bit of a conflict. So we are going to have to have a third day, this being the second day, with your presence here.

We know that you would have preferred to have been here yesterday, but because of the summit were unable to be with us, and I think the 24th of this month is the day we will hear from others who will be coming in who have a different point of view on the legislation that you feel so strongly about.

But yesterday was a productive day I thought and very worthwhile, and we had excellent testimony from people who do support the approach.

The issues raised by your proposal are extremely contentious, as you know. It has been called a turf war between agencies and between committees. Each side has raised allegations about which side is the better regulator.

I am concerned that if the debate remains at that level, however, we will never get down to the real issue, which is how to design a regulatory structure for stock and stock index futures that best serves the capital formation needs of our country.

Secretary Brady, I have expressed to you in the past my frustration that members of the administration have not been able to work out these issues as a team. I know that is a source of frustration for you as well.

Perhaps the SEC and the CFTC are so far apart philosophically in terms of the mission those agencies serve that it is impossible to get them to agree.

Nonetheless, I believe it is important this afternoon that you share with us just why the agencies cannot agree, why the administration cannot work out these issues at the executive branch level and why legislation is necessary at all.

I happen to agree with you that it is absolutely imperative that we reach a solution and reach one soon. These agencies and the respective markets simply are not working closely enough together, and if the private markets cannot work things out, if the agencies cannot work things out and if the administration cannot use its powers of persuasion to bring the parties together, then I believe it will become our responsibility.

I personally have very good friends and colleagues on both sides of this issue. I have the highest respect for Wendy Gramm and Richard Breeden as well as for the industry leaders on both the securities and the futures side. Tackling these very contentious issues is not a task that I relish, but one that I think we've got to face head on.

So, again, we thank you for being with us this afternoon and look forward to your testimony, but before doing that, let me turn to Senator Garn and other colleagues for any opening comments they may have.

Senator GARN. Thank you, Mr. Chairman.

The Secretary does have a rather tight time schedule this afternoon. So I would ask unanimous consent that my statement be placed in the record, and I will just read one paragraph.

Senator DODD. Without objection, all statements will be included in the record.

Senator GARN. The only reason I'll read this one paragraph is I want the Secretary to feel real good before Senator Dixon starts on him. [Laughter.]

Senator DODD. You had better make him feel real good. [Laughter.]

Senator GARN. That's why I choose to put most of my statement in the record, but this is also an issue that Nick Brady knows as well as anyone. His stellar career on Wall Street and his role as Chairman of the President's Task Force on Market Mechanisms and his position as Secretary of the Treasury make him uniquely qualified to judge what actions are necessary to strengthen our Nation's capital markets. I have enormous respect for his judgment and dedication and usually, but not always, find myself in agreement.

So we'll start you off on a positive side, and I'll be here to protect you from Senator Dixon.

[The opening statement of Senator Garn follows:]

OPENING STATEMENT OF SENATOR GARN

Senator GARN. It's always a pleasure to welcome Nick Brady to the committee. This afternoon he appears before us to discuss the administration's market reform bill. While he has been before this committee on numerous occasions discussing a variety of topics, I know that few, if any, are as important to him as this one.

This is also an issue that Nick Brady knows as well as anyone. His stellar career on Wall Street, his role as the Chairman of the

President's Task Force on Market Mechanisms, and his position as Secretary of the Treasury, make him uniquely qualified to judge what actions are necessary to strengthen our Nation's capital markets. I have enormous respect for his judgment and dedication and usually find myself in agreement with his views.

Having said that, as I noted yesterday, I am not persuaded that the full range of proposals in the administration's legislation is necessary to strengthen regulation of our markets. In particular, I'm not sure that shifting regulation over certain financial products from the governmental entity to another will significantly lessen the likelihood of another market decline.

I do want to take exception, however, to the contention of those who argue that the administration's bill is a simple case of turf-grabbing. I know that Nick Brady feels very strongly that the legislation is in the public interest and will enhance the competitiveness, efficiency, and stability of our capital markets. This was also not a case where the members of the Banking Committee sat down and tried to come up with ways to wrest jurisdiction from the Agriculture Committee. I'm sure you would have heard loud screams well before now if that was the case.

I don't want to suggest that there aren't steps that can be taken to enhance oversight of our markets without unduly interfering in their operation. In particular, I strongly support passage of the two measures that this committee has previously reported, the Market Reform Act and the Securities Law Enforcement Remedies Act. I believe you support those legislative initiatives as well. It is also important that we recognize that the administration's bill raises very important issues apart from a jurisdictional transfer, including oversight of margins and resolving the problems raised by the "exclusivity" clause in the Commodity Exchange Act.

I just hope that the heated rhetoric over whether the CFTC or SEC does a better job of regulating markets doesn't cause us to lose sight of these other important issues and legislative initiatives.

Senator DODD. Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, this is the committee's second day of hearings on S. 2814, the administration bill known as the Capital Markets Competition, Stability and Fairness Act of 1990.

At the outset it seems to me it's appropriate to review the steps we have taken to ensure that we can better respond to any future episode like October 1987.

As all of my colleagues here know, the Brady Commission looked into that crash and reported back five major recommendations: One, coordinated clearing; two, circuit breaker mechanisms; three, improved information systems; four, one agency coordinating a few regulatory issues that have an impact across the markets; as well as five, margins that are consistent across markets.

S. 648 was reported by this committee last November, and it contains provisions that will aid coordination of the clearing process. That is the bill held on the calendar now by the administration.

The New York Stock Exchange and the Chicago Mercantile Exchange with the approval of the CFTC and the SEC have put in a system of circuit breakers. Both S. 648 and S. 1729, the two bills on the calendar held by the administration and the CFTC reauthorization bill also waiting floor action have provisions that will help improve information systems and which significantly enhance the ability of the SEC and the CFTC to prevent market abuses, including intermarket abuses.

While we do not have one agency coordinating the intermarket issues, we do have the Presidential Working Group in place that provides a forum and a regular opportunity for dealing with issues that cut across markets.

I also think that it's worth noting that one agency is not always the best approach. As my friend, the Secretary of the Treasury knows, there are three bank regulators even though there is one market. And when we enacted the Savings and Loan bill last August where there was one regulator, we split savings and loan regulation into two separate pieces. That was the recommendation of my friend sitting there at the witness table giving part to the OTS and part to the FDIC.

That brings us to the final recommendation regarding margins. When Chairman Greenspan who was here this morning of the Federal Reserve Board appeared before this committee on March 29 of this year here is what he said, and I quote:

> The Board, as best I can judge, is unanimous on the question that the appropriate margins for stock index futures and for stocks should be prudential only. Had we found such a relationship between margins and volatility, I suspect we would be arguing that margins should be constructed in a manner which picked up not only prudential requirements, but also an element of additional margin which would act to presumably suppress the degree of volatility in the system. All of the analytical tools we have brought to bear have filed to find any such relationships.

Now this is Chairman Greenspan.

> As a consequence of that, we are unanimous—that is the Fed—on the issue that prudential margins are the realistically sole purpose of putting margins in place.

The recent report of the New York Stock Exchange chaired by Roger Smith makes exactly the same point commenting on index arbitrage. The mechanism that links the stock in futures markets, the study said, and I quote directly: "There is little evidence that index arbitrage causes an increase in volatility as usually measured."

So futures margins don't contribute to stock market volatility and neither does index arbitrate between the markets. That's the experts, and it's not the Chicago Futures Exchanges that say this, but rather the Federal Reserve Board and the New York Exchange study itself.

It seems to me therefore, Mr. Chairman, that given the differences between what the stock exchanges and the futures exchanges mean when they say margins, and the meanings are altogether different, given the fact that the futures exchanges clear overnight instead of every 5 days, and given that the evidence is clear that margins do not contribute to volatility, then margins, in my view, are not a problem.

I think we should quickly enact the reforms reported by this committee and the Agriculture Committee that are now on the floor, and I say that to the administration and to my friend, the

Secretary of the Treasury, S. 648 and S. 1729, two good pieces of legislation.

I think we could continue to build in the cooperative work that has already gone on between the futures exchanges and the stock exchanges, and I think we should look into the one intermarket issue that we've not previously reviewed, IP's.

The administration's bill, as the Chair points out, is controversial. It cannot and will not be acted on quickly. There is a strong consensus, a strong one behind the reform of this committee and the Agriculture Committee have already acted on, S. 648 and S. 1729, and I believe these necessary bills should not be further delayed.

I thank the Chair for his indulgence——

Senator DODD. I thank the Senator from Illinois.

Senator DIXON [continuing]. And my friend, the Secretary of the Treasury for his.

Senator DODD. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairma, I join in welcoming the Secretary, and I can only observe that particularly in view of some of the comments I've just heard, that a lot of people totally really don't understand what the word prudential means.

The Congress and the regulators didn't understand what prudential meant in the case of S&L's. There was supposed to be prudential regulation by what was then the FSLIC and the Home Loan Bank Board going back into the early 1980's, and there wasn't, and we got a mess, a $130 billion mess. If you don't finance it, it's $130 billion.

I've just heard one more example of why we are likely to set the stage for another savings and loan disaster. I've just heard one of our colleagues describe at length why margins are set prudentially, and since margins don't contribute to volatility, then everything is fine, as if the issue of whether or not margins and the levels they were set at were irrelevant to whether or not there were risks.

Then term prudential includes not just setting margins with respect to some notion of volatility, but exposure to risk, and the bottom line is whether we want to continue to risk the stability of our capital markets because of what some people describe as a turf fight. This is in fact an issue of subsidy, a subsidy that somebody else is going to have to pay, ultimately the taxpayer or the investor if the markets go down while other people are clipping their commission coupons.

I look at the $130 billion cost of the S&L bailout aghast, like all of my constituents, and then I think well, it was 13 percent of the $1 trillion that disappeared from the markets during the 4-day period of October 14 through 19.

Now people are aghast of the $130 billion, and we blithely talk about how everything is just fine, don't worry about margins, that's all related to volatility, and let's ignore risk. When we ignored those issues in October 1987, it cost somebody not $130 billion, but $1 trillion, and at some point you've go to begin saying we're talking about real money. If we are not at that point now, I don't know where or when it is.

Now one or two of our colleagues, Mr. Secretary, have said with respect to the administration's proposed legislation that it's a dog that won't hunt. Well, I'm sorry to say that Congress' excuses for failing to enact recommendations more than 2½ years ago following the stock market crash just won't fly with small investors, with corporations that need to raise capital and others who understand the importance of our capital markets.

Maybe there is an issue of turf here, but it seems to me that the country's well being ought to come before individual turf or personal self-interest or the interests of a small segment if they are really at risk. I don't happen to think they are at risk because, as I said yesterday, and I will say it again, I happen to think that to the extent that this is a turf fight between the people in Chicago versus some other power center represented by the SEC, I find it in the final analysis difficult to believe why people in Chicago would not have, if they understood the situation and if they could step back from the situation in which they find themselves engaged, that ultimately what is going to be good for America is going to be good for them.

So I look forward to hearing your testimony, and I'll have a number of questions.

Senator DODD. I note the presence of Senator Simon from Illinois as well, but I'm going to ask members of the committee if they have any opening statements first.

Senator SIMON. I thank you for even tolerating me here, Mr. Chairman. I am very interested in this.

Senator DODD. Let me turn to my other members of the committee first before I come back to you.

Senator SIMON. Oh, excuse me.

Senator DODD. Senator D'Amato.

Senator D'AMATO. Mr. Chairman, obviously this is an issue of great concern. Certainly market volatility that has resulted in, or may have resulted in the kind of price fluctuation we are seeing and that is so disquieting to the market and to our investors is something that I think this committee is very appreciative of the ramifications and we have to address.

I look forward to the Secretary's testimony, and also to his responses to what I know will be some probing questions as to the adequacy of the legislation in dealing particularly with that volatility, if indeed that is the answer to the questions that I think have troubled so many of us.

I will forgo and ask that the balance of my statement be placed in the record as if read in its entirety.

Senator DODD. Without objection, so ordered.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, today the committee continues its consideration of financial services modernization. We are fortunate to have with us today Federal Reserve Chairman Alan Greenspan.

Clearly any reform proposal must focus on promoting safety of the Nation's financial system, while at the same time preventing anticompetitive abuses that ultimately harm millions of small investors and passbook holders.

Reform must also recognize the evolving globalization of financial markets and services, and the ever increasing competition among nations for financial service markets. Our domestic system of financial regulation can no longer be premised on local, parochial considerations. It must be infused with the requisite global, forward-looking reform that places U.S. institutions in a position of competitive advantage.

I look forward to hearing the remarks of today's witness.

Senator DODD. Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you very much, Mr. Chairman.

Senator Brady, we are happy to continue this discussion with you.

In your testimony and in previous statements I want to note for the record that you have responded to concern which has been expressed in my State and other farm States that you are not seeking in this measure, this is not a foot in the door to weaken the CFTC or to give the SEC authority to become involved in ag commodities.

I thank you for that reassurance. I think it is extremely important that we have it on the table before we begin. I don't think the SEC would do well with hog bellies, wheat, corn, soybeans, and other items.

Second, I apologize that I have another hearing in which I have to participate, and I may not have the opportunity to be here for the questions.

I wanted to re-emphasize to you, as I did in the hearings yesterday, that I share your concern about the major market disruptions, the free falls that we've seen in the market.

I'm also concerned, as we have discussed, about our ability to detect and control intermarket fraud. I think we need to address these problems. I think that we are suffering right now from the lack of participation by small investors in the market which is damaging to our economy and it deprives many small investors of the returns that they ought to be able to enjoy in the market.

I think that action is needed. I have stated previously that it does not appear to me from the samplings that I have had that we have been able to resolve the disputes over CFTC or SEC regulations sufficient to pass the measure that has been recommended by the administration.

I want to explore doing as much as possible to address the central issue of prevention of major market disruption, and that's why I have raised with other witnesses and would raise with you if I have the opportunity your reaction to providing the Federal Reserve the authority to oversee margins with or without delegation to both the CFTC in futures and the SEC on stocks as they do now, the ultimate margins which would come from the exchanges.

I look forward to hearing your testimony, which I have already reviewed in writing, and I hope that we will have the opportunity to talk about areas in which we can move this badly needed change in administration forward.

Thank you, Mr. Chairman.

Senator DODD. Thank you.

Senator Roth.

Senator ROTH. Mr. Chairman, I'm anxious to hear as much as I can from Mr. Brady before I have to leave.

So welcome here, Mr. Secretary.

Senator DODD. Thank you, Senator Roth.

Before we begin I have a statement from Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman, for scheduling this hearing on the capital markets legislation that's being advanced by Secretary Brady. I want to join in welcoming the Secretary here today and say that I look forward to his testimony. Secretary Brady should be complimented for his leadership on this issue that goes back over 2 years to his Brady Commission report.

Mr. Chairman, volatility in the securities markets is a troubling issue. I am impressed that the business community, and not just the securities industry, seems now to believe that the Secretary's legislation will dampen volatility.

We have to be concerned not just with the flight of the small investor, but also the extremely short-term view that this volatility confers on the management of American corporations. Our business leaders need to take a longer view, if our companies are going to be able to compete in the increasingly global marketplace.

Mr. Chairman, I want to thank you for scheduling this hearing. I look forward to Secretary Brady's testimony.

Senator DODD. We welcome you, Senator Simon, for any brief comments you may have before we get to the Secretary.

OPENING STATEMENT OF SENATOR SIMON

Senator SIMON. They will be brief, and I'm honored to be associated with this committee here just for a moment today.

I wanted to come over because we're talking about an area that obviously is important to the Nation and specifically to the economy of my State.

Secretary Brady was good enough 3 months ago or so to come and spend some time with Senator Dixon and myself in my office where we discussed this, and frankly up until that point I really hadn't been doing real in-depth digging on this whole question.

Secretary Brady basically has assumed that the volatility that we experienced in the stock markets was contributed to or aggravated significantly by the futures market and the lack of adequate margins there.

I have since that time been reading through everything the Congressional Research Service has been able to dig up.

An article I would commend to the Secretary of the Treasury for whom I have great respect is an article that appeared in the Cornell Law Review of all places written by Dean Furbish, an economist with the Securities and Exchange Commission, and a Professor Annette Polson of the University of Georgia.

Their conclusion, if I can just quote three sentences here:

> The evidence presented here does not support a policy decision of higher margins in futures markets. Even if low margins encourage speculative trading, there is no empirical support for the view that speculators raise price volatility, and theoretical reasoning supports the view that speculators provide liquidity to markets. Recent evidence, although limited, suggests that higher margins for stock index futures are not associated with lower price volatility in futures markets.

It is a very solid piece, somewhat academic, but I would encourage anyone whose ideas are on the margin in this regard, anyone who isn't certain yet of where we should go read this really solid piece of work that has been done.

Again, I thank you for tolerating me here in your committee.

Senator DODD. I would invite you, not to preempt the Secretary, but I would invite you to turn to page 8 of his testimony today, paragraph 3, and I think you will get a response to the very last point on the question of volatility on margins.

Mr. Secretary, welcome.

STATEMENT OF NICHOLAS F. BRADY, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary BRADY. Thank you, Chairman Dodd, for the opportunity to testify today.

Before I start, I would just make one comment that was made by Senators in their statements, that there is some variation in the administration's approach to this issue. I would only say that, as far as I know, that is not the case.

In fact, although I don't have it with me, I know we wrote a letter to Senator Dixon, which I would be glad to supply this committee, which is signed off by the Director of the Office of Management and Budget, which collects all the administration's views, and by myself and Chairman Boskin. So the administration is solidly behind this proposal. Now when you come to independent agencies, I think we all understand that they are independent.

Thank you for this opportunity to present the administration's legislative proposal affecting the stock and stock index futures markets, S. 2814, "The Capital Markets Competition, Stability, and Fairness Act of 1990." I believe this legislation is important, and I urge its immediate passage.

Why do we need a change? Well, there are a number of reasons. We have experienced repeated violent drops in the stock market in the absence of any significant news events. We have done little to respond, and as a result we are taking a chance with the very essence of the system, the clearance and settlement process.

Perhaps most important, we have damaged the confidence of individual investors. I strongly believe that any market system that disillusions and disenfranchises the individual investor will lose its political standing and in the end its greatest strength.

Let me be specific. Three weeks ago, on Friday, June 22, 1990, in the last few minutes of trading, the stock market plunged 64 points on no significant news. Sell programs kicked in shortly after 3 p.m., and in the last half hour of trading accounted for more than half of the S&P 500 trading volume.

On Friday, October 13, 1989 the Dow Jones Industrial Average fell 191 points. Almost 90 percent of the drop occurred in the last

90 minutes of trading, supposedly triggered by news of a failed takeover attempt for a single company.

The following Monday, October 16, the market lost 63 points in the first 40 minutes of trading, and then sharply rebounded to close 88 points up for the day.

A week later, on October 24, 1989, the S&P 500 dropped 2.7 percent, roughly 90 Dow points, and the price of the S&P futures contract dropped 3.2 percent in slightly over 1 hour of trading.

And in October 1987 the Dow Jones Industrial Average lost almost a third of its value, $1 trillion, in just 4 days. This included the 1-day drop of 508 points, or 22 percent, the largest recorded amount since Dow Jones started computing index numbers in 1885.

Moreover, the very real prospect of clearinghouse failures in the wake of this crash led to a crisis of confidence that brought the system to the brink. While we all remember these consequences, few can remember what caused them.

I just pause for a minute. Can anybody think back to the 1987 sell-off of 500 points remember why it happened?

Indeed, in each of these episodes, minor, even untraceable events, appear to have triggered precipitous violent market declines. Each episode occurred in the last 3 years when stock index futures have been actively trading in large volumes, and each episode constituted a major market disruption, a period when the markets for stocks and stock index futures disconnect with prices sprialing down.

These major market disruptions create clear and obvious risks to the system, but they also turn off individual investors who feel the whole system is stacked against them.

Those who are in the best position to judge the mood of the individual investor, the stock exchanges and the large retail brokerage houses like those who testified yesterday, report a growing disillusionment with the stock market by such investors.

This trend is disturbing. Individuals bring to the market a diversity of views, which is source of stability. Indeed, individuals were net buyers during last October's downdraft and appeared to stop the market from plunging even further.

More importantly, political support for our free market system rests on the foundation of broad based individual support. As I said before, when markets operate to disenfranchise the individual investor, they lose that political standing and in the end their greatest strength.

Let me emphasize that when I use the term "major market disruption," I'm not talking about increased volatility, which has become a word that people want to use in order to justify a point of view, and an issue that is incredibly popular with economists.

Critics charge that there is no compelling evidence of increased stock market volatility or average price swings. They may be right, but the focus on volatility is a red herring. Our concern is not average price changes, but the episode of violent market freefalls.

I think in analogies from time-to-time, and if you want to talk about volatility, you ought to think about a heart patient that is being monitored by a graph. Obviously every time his heart beats the graph goes up and down, but when you see a violent swing up or a violent swing down, that's when the doctors and nurses run into the room and that's what we're talking about here, violent market disruptions.

During these major market disruptions, pricing relationships between stocks and futures break down. Markets in particular stocks experience difficulties in staying open. Serious supply demand imbalances develop, and very large market moves occur in the absence of underlying fundamental information.

Let me just refer again. Can anybody remember the reason why the stock market dropped 500 points in 1987, or can they remember the reason why it went off 190 points in 1989?

These sudden declines unrelated to changes in underlying fundamental information are a new market phenomenon. In the past large market moves were relatively infrequent and associated with news events that clearly affected fundamental values.

Again, let me be specific. In the 42 years between 1940 and 1982, the year stock index futures began trading, the Dow Jones Industrial Average declined by more than 6 percent on only three occasions: When the Germans took the Netherlands in May 1940, a decline of 6.8 percent; when they encircled the Allied Forces at Dunkirk just 6 days later in the same month, 6.8 percent; and when President Eisenhower suffered a heart attack in September 1955, again a change of 6½ percent.

By contrast, with the growth of stock index futures trading, such massive 1-day selloffs have occurred four times in the last 3 years: October 19, 1987, minus 22 percent; October 26, 1987, minus 8 percent; January 8, 1988, minus 6.9 percent; October 13, 1989, minus 6.9 percent.

I don't want to bore you with this testimony, but can anybody remember the reason why these declines took place?

Not one of these days corresponded with any major news events like the ones before 1982, but they all shared the characteristic of enormous selling pressure from the stock index futures markets flowing over to the stock market.

My point is this. Stock and stock index futures are one market linked together by electronics. Movements in the price of stock index futures are translated almost immediately to stock prices through index arbitrage, and vice versa.

That is what we concluded in the President's 1987 Task Force on Market Mechanisms, and essentially no one, not academics, not people on Wall Street, and not politicians, has disputed that conclusion. I might just show you this book which we put together in 1987. It's some 400 pages long and it has been examined for 3 years. Its basic conclusion is we have one market that exists irrespective of geography with the development of electronics and the transmission of instantaneous information, and I have never seen in the intervening period of time anyone who disagreed with that conclusion.

The task force also concluded that the interaction of trading in stock and stock index futures in the one market is a major cause of market disruptions. Yet, the Nation's disjointed regulatory system has not kept pace with this reality, preventing us from putting the "one market" tools in place to deal with these market disruptions.

The single most important step Congress can take to reduce both the likelihood of major market disruptions and the severity of their consequences is to unify regulation for the one market.

A single regulator would be able to coordinate the key intermarket mechanisms that disconnect to create or make larger major market disruptions. While the problem of major market disruptions would not be magically cured overnight, unified regulation could at least begin to develop and apply the regulatory tools to control what is too often out of control, the interaction between stock index futures and stocks.

Moreover, I strongly believe that if we fail to come to grips with regulatory fragmentation, the Government will have done precious little in the face of clear evidence that we've got a problem. As I have said before, minor events are likely to continue to cause major market disruptions, and major events could cause even worse results. Simply stated, we are accepting too much systemic risk for too little benefit.

The administration believes that Congress should act by passing the administration's bill. Before I describe the bill in more detail, let me briefly explain the specific problems that I believe require this legislative remedy.

UNCOORDINATED INTERMARKET MECHANISMS

The first of these is the failure to coordinate key intermarket mechanisms which would not happen if the "one market" were regulated as one market. These mechanisms, which we have described at length in previous testimony, include unharmonized margins, disjointed clearance and settlement systems, evasion of short-selling restrictions, and uncoordinated circuit breakers.

As you know, while there is Federal oversight of margins on stocks, there is virtually none over margins on stock index futures. The futures exchanges and their clearinghouses set these margins on futures themselves. The result is a tremendous disparity in margin levels on stock and stock index futures, even though they are part of one market where margin levels on one instrument can have a direct impact on the trading and price of the other.

The result has been that futures margins, which have no Federal oversight, have often dipped to dangerously low levels. Indeed, Chairman Greenspan of the Federal Reserve Board, the guardian against excessive risk to the financial system in our country, recently expressed his strong concerns to this committee about the low level of stock index futures margins prior to the mini-crash last year.

Again, those who try to dismiss our proposal by claiming that margins are unrelated to volatility are simply missing the point. We have never said that average volatility has increased. Our concern is major market disruptions and how to slow them down when the tidal wave starts to form, not everyday volatility which everybody expects.

The Federal Reserve Board agrees with the need for Federal oversight of margins on stock index futures to limit systemic risk. Indeed, no credible argument has ever been advanced against Federal oversight. We must have it where the actions of private market participants in a narrow segment of the market create risks for the financial system as a whole. It is a dangerous practice that is not in the public interest. We ought to address that unjustified anomaly and address it now.

Let me elaborate on the link between margins and systemic risk. The fact is that futures traders can control large amounts of stock with little of their own money. Relatively small amounts of capital can concentrate enormous selling pressure on the stock market. For example, just prior to the October 13, 1989 break, a professional trader in the futures market with $50,000 in cash could control roughly $2 million in stock, which is nearly 10 times more than the $200,000 that a professional trader in the stock market can control with the same amount of cash.

Many observers were astounded that while stock index futures margins were increased temporarily in the wake of the 1987 break, they were soon again lowered, so that margins were lower in October 1989 than they were in October 1987. Futures margins were 3.6 percent at the opening on October 19, 1987. They were then raised to above 12 percent the following week, but then allowed to drift back down so that at the opening on October 13, 1989, the day the market dropped 190 points, they were only 2.2 percent.

Today margins on the S&P 500 futures contract are only about 4 percent, which means that a decline of just 4 percent, about 120 points on the Dow Jones Average, faces a future trader with a choice. He either has to double his original margin simply to hold an existing position or sell out, which could put more pressure on a falling market.

A consequence of low margins is that during market downdrafts, when the system is most in need of liquidity, futures exchanges are forced to restrict liquidity through increased margin requirements because margins have been set so low. This is precisely the opposite of what should occur. During emergencies it is critical to pump liquidity into the system. Indeed Chairman Greenspan testified before this committee that during last October's mini-crash he was "shaken," to use his word, at the prospect of increasing margins at a time when liquidity was critical.

In addition to margins, three other intermarket mechanisms require coordination. First, the disjointed clearing and settlement systems impose risks to the entire financial system. Second, concerted selling in the futures market can completely undermine short selling restrictions which were placed more than 50 years ago on the stock market. And third, circuit breakers require further coordination to be fully effective.

Each of these mechanisms is described in more detail in my written testimony.

In short, fragmented regulation has impeded progress on the coordination of these fundamental intermarket mechanisms. We believe one regulator with appropriate authority could accelerate progress substantially toward the harmonized regulation we need to address the problem of major market disruptions.

One regulator is what every other country with important trading in these instruments has—the United Kingdom, Japan, and France.

INEFFECTIVE INTERMARKET ENFORCEMENT

Another problem created by regulatory fragmentation involves intermarket enforcement. With two different regulators it is sometimes hard to prevent manipulation and fraud in transactions between the stock and futures markets.

In particular, it is extremely difficult to detect intermarket "frontrunning," where a trader trades ahead of his client in one market knowing that the client's trade will drive a linked market in a particular direction. In fact, at this time there is not even a universally accepted definition of illegal frontrunning in the cross-market context. The current fragmented regulatory system is an open invitation for intermarket manipulation.

BARRIERS TO INNOVATION

Let me make one final point. Apart from major market disruptions and intermarket enforcement, regulatory fragmentation also is creating a serious impediment to innovation. For example, as we describe in more detail in the written statement, jurisdictional litigation has prevented index participation certificates from trading in the United States.

THE ADMINISTRATION'S PROPOSAL

Now let me talk for a minute about our proposal. To remedy all of these problems, the administration has proposed the "Capital Markets Competition, Stability, and Fairness Act of 1990." The bill contains three key provisions which are described in more detail in my written statement.

First, the bill transfers the authority to regulate stock index futures from the CFTC to the SEC, but in a manner specifically designed to create the least disruption to market participants.

Second, it provides Federal oversight authority over the ability of futures markets to set margins on stock index futures, not to prevent volatility, but to safeguard the financial system.

Third, the bill modifies the "exclusivity clause" of the Commodity Exchange Act to end costly and anticompetitive legal disputes over what constitutes a futures contract.

CONCLUSION

In conclusion, we believe the administration's proposal will accomplish the two major purposes we have in mind. The first is to reduce both the likelihood of major market disruptions and the severity of their consequences. The second is to create a market environment that rekindles the interest of the individual investor.

Furthermore, the administration's proposal is not the proverbial "camel's nose under the tent." The way markets are now functioning makes no further shifts in regulatory jurisdiction necessary, not Treasury bond futures to the SEC and not a full merger of the SEC and the CFTC. I will oppose more sweeping changes to CFTC authority if the administration's bill passes in its present form.

Would the CFTC be rendered a less effective regulatory body if the bill passes? No. The CFTC would be able to concentrate its expertise on the more traditional agricultural and financial futures products that have long been the core of its jurisdiction. Indeed, our proposal would have minimal effect on the CFTC because stock index futures represent less than 10 percent of the futures volume under CFTC jurisdiction.

In fact, I believe moving jurisdiction over stock index futures to the SEC makes it more likely the CFTC will survive as an independent agency. Further episodes of severe market disruptions could build pressure to merge the CFTC and the SEC, as proposed in the recently introduced Glickman/Eckart bill in the House of Representatives.

Concerns that our bill would strangle stock index futures are also unfounded. I expect the changes we propose would increase investor confidence in the stock index futures markets and would attract the interest of investors who do not currently use these instruments.

What impact would our proposal have on the individual farmer and the agricultural community in general? None whatsoever. Stock index futures simply have no relation to agricultural products or agricultural futures.

Finally, opponents of the bill have tried to characterize these issues as nothing more than a turf fight between Government agencies or congressional committees, or a regional battle between financial centers. Turf is not the issue, nor is it a geographical battle between Chicago and New York. In fact, some of the largest traders on the futures exchanges are New York investment houses.

The Treasury Department comes to this issue with no particular parochial perspective. Our sole objective is sound public policy, how best to reduce the likelihood of violent market disruptions and position our markets for continued leadership in the face of mounting competition around the world.

Moreover, let me emphasize that the problems I have described do not come from the CFTC or the SEC. These regulators are doing a good job under difficult circumstances—trying to administer a system of regulation that is simply not in concert with the one-market reality that exists today. It is unfair to expect them to regulate markets effectively without the proper tools to do so.

Our concern, as I have explained, is the few but critical intermarket issues that are slipping through the regulatory cracks. Unless properly coordinated through a coherent regulatory structure, these few issues pose a serious risk to our financial system.

For the reasons I have outlined, I believe the need to adopt the legislation we have proposed is urgent.

Thank you, Mr. Chairman.

[The complete prepared statement of Secretary Brady follows:]

Statement of the Honorable
Nicholas F. Brady
Secretary of the Treasury
Before the
Senate Committee on Banking, Housing, and Urban Affairs

July 12, 1990

Chairman Riegle, Senator Garn, Senator Dodd, Senator Heinz, and members of the Committee:

Thank you for this opportunity to present the Administration's legislative proposal affecting the stock and stock index futures markets, S.2814, "The Capital Markets Competition, Stability, and Fairness Act of 1990." I believe this legislation is important, and I urge its immediate passage.

Why do we need change? There are a number of reasons. We have experienced repeated, violent drops in the stock market in the absence of any significant news events. We have done little to respond, and as a result, we are taking a chance with the very essence of the system, the clearance and settlement process. Perhaps most important, we have damaged the confidence of individual investors -- I strongly believe that any market system that disillusions and disenfranchises the individual investor will lose its political standing, and in the end its greatest strength.

Let me be specific.

Three weeks ago on Friday, June 22, 1990, in the last few minutes of trading, the stock market plunged 64 points on no significant news. Sell programs kicked in shortly after 3 p.m., and in the last half hour of trading accounted for more than half of S&P 500 trading volume.

On Friday, October 13, 1989, the Dow Jones Industrial Average fell 191 points. Almost 90 percent of the drop occurred in the last 90 minutes of trading, supposedly triggered by news of a failed takeover attempt for a single company. The following Monday, October 16, the market lost 63 points in the first 40 minutes of trading, then sharply rebounded to close 88 points up on the day. A week later, on October 24, 1989, the S&P 500 index dropped 2.7 percent (roughly 90 Dow points) and the price of the S&P index futures contract dropped 3.2 percent in slightly over one hour of trading.

And in October of 1987 the Dow Jones Industrial Average lost almost a third of its value -- $1.0 trillion -- in just four days. This included the one-day drop of 508 points, or 22.5 percent, the largest recorded amount since Dow Jones started computing index numbers in 1885. Moreover, the very real prospect of clearinghouse failures in the wake of this crash led to a crisis of confidence that brought the system to the brink of breakdown. While we all remember these consequences, few can remember what caused them.

Indeed, in each of these episodes, minor, even untraceable, events appear to have triggered precipitous, violent market declines. Each episode occurred in the last three years, when stock index futures have been actively trading in large volumes. And each episode constituted a major market disruption, a period when the markets for stocks and stock index futures disconnect with prices spiraling down.

These major market disruptions create clear and obvious risks to the system. But they also turn off individual investors, who feel the whole system is stacked against them. Those who are in the best position to judge the mood of the individual investor -- the stock exchanges and the large retail brokerage houses like those who testified yesterday -- report a growing disillusionment with the stock market by such investors.

This trend is disturbing. Individuals bring to the market a diversity of views, which are a source of stability -- indeed, individuals were net buyers during last October's downdraft and appeared to stop the market from plunging even further. More importantly, political support for our free market system rests on the foundation of broad-based individual ownership. As I said before, when markets operate to disenfranchise the individual investor, they lose that political standing and in the end their greatest strength.

Let me emphasize that when I use the term "major market disruption," I am not talking about increased volatility, an issue so popular with economists. Critics charge that there is no compelling evidence of increased stock market volatility or average price swings. They may be right, but the focus on volatility is a red herring. Our concern is not average price changes, but the episodes of violent market freefalls. During these major market disruptions, pricing relationships between stocks and futures break down; markets in particular stocks experience difficulties in staying open; serious supply-demand imbalances develop; and very large market moves occur in the absence of underlying fundamental information.

These sudden declines unrelated to changes in underlying fundamental information are a new market phenomenon. In the past, large market moves were relatively infrequent and associated with news events that clearly affected fundamental values.

For example, in the 42 years between 1940 and 1982 (the year stock index futures began trading) the Dow Jones Industrial Average declined by more than 6 percent on only three occasions:

when the Germans took the Netherlands in May of 1940 (6.8 percent); when they encircled the Allied forces at Dunkirk just days later in the same month (6.8 percent); and when President Eisenhower suffered a heart attack in September of 1955 (6.5 percent).

By contrast, with the growth of stock index futures trading, such massive one-day selloffs have occurred four times in the last three years:

October 19, 1987 -- 22.6 percent
October 26, 1987 -- 8.0 percent
January 8, 1988 -- 6.9 percent
October 13, 1989 -- 6.9 percent

Not one of these days corresponded with any major news events like the ones before 1982. But they all shared the characteristic of enormous selling pressure from the stock index futures markets flowing over to the stock market.

My point is this. Stocks and stock index futures are "one market," linked together by electronics. Movements in the price of stock index futures are translated almost immediately to stock prices through index arbitrage, and vice versa. This is what we concluded in the President's 1987 Task Force on Market Mechanisms, and essentially no one -- not academics, not people on Wall Street, not politicians -- has disputed that conclusion. The Task Force also concluded that the interaction of trading in stock and stock index futures in the "one market" is a major cause of market disruptions. Yet the Nation's disjointed regulatory system has not kept pace with this reality, preventing us from putting the "one market" tools in place to deal with these market disruptions.

The single most important step Congress can take to reduce both the likelihood of major market disruptions and the severity of their consequences is to unify regulation for the "one market." A single regulator would be able to coordinate the key intermarket mechanisms that disconnect to create or exacerbate major market disruptions. While the problem of major market disruptions would not be magically cured overnight, unified regulation could at least begin to develop and apply the regulatory tools to control what is too often out of control -- the interaction between stock index futures and stocks.

Moreover, I strongly believe that if we fail to come to grips with regulatory fragmentation, the government will have done precious little in the face of clear evidence that we face a problem. As I have said before, minor events are likely to continue to cause major market disruptions -- and major events could cause even worse results. Simply stated, we are accepting too much systemic risk for too little benefit.

The Administration believes that Congress should act by addressing the regulatory structure for stocks and stock index futures. We have proposed legislation with three key provisions. First, the bill transfers the authority to regulate stock index futures from the Commodity Futures Trading Commission (CFTC) to the Securities and Exchange Commission (SEC), but in a manner specifically designed to create the least disruption to market participants. Second, it provides federal oversight authority over the ability of futures markets to set margins on stock index futures -- not to prevent volatility, but to safeguard the financial system. Third, the bill modifies the "exclusivity clause" of the Commodity Exchange Act to end costly and anticompetitive legal disputes over what constitutes a "futures contract."

Before I describe the bill in more detail, let me briefly explain the specific problems that I believe require this legislative remedy.

Uncoordinated Intermarket Mechanisms

The first of these is the failure to coordinate key intermarket mechanisms, which would not happen if the "one market" were regulated as one market. These mechanisms, which we have described at length in previous testimony, include unharmonized margins, disjointed clearance and settlement systems, evasion of short selling restrictions, and uncoordinated circuit breakers.

Unharmonized Margins. As you know, while there is federal oversight of margins on stock, there is virtually none over margins on stock index futures. The futures exchanges and their clearinghouses set these futures margins themselves. The result is a tremendous disparity in margin levels on stocks and stock index futures, even though they are part of one market where margin levels on one instrument can have a direct impact on the trading and price of the other.

The result has been that futures margins, which have no federal oversight, have often dipped to dangerously low levels. Indeed, Chairman Greenspan of the Federal Reserve Board -- the guardian against excessive risk to the financial system -- recently expressed his strong concerns to this Committee about the low level of stock index futures margins prior to the mini-crash last year.

Again, those who try to dismiss our proposal by claiming that margins are unrelated to volatility are simply missing the point. We have never said that average volatility has increased. Our concern is major market disruptions and how to slow them down when the tidal wave starts to form -- not volatility.

The Federal Reserve Board agrees with the need for federal oversight of margins on stock index futures to limit systemic risk. Indeed, no credible argument has been advanced against federal oversight -- we must have it where the actions of private market participants in a narrow segment of the market create risks for the financial system as a whole. It is a dangerous practice that's not in the public interest. We ought to address this unjustified anomaly.

Let me elaborate on the link between margins and systemic risk. The fact is that futures traders can control large amounts of stock with little of their own money. Relatively small amounts of capital can concentrate enormous selling pressure on the stock market. For example, just prior to the October 13, 1989 break, a professional trader in the futures market with $50,000 in cash could control roughly $2,000,000 in stock, which is nearly 10 times more than the $200,000 that a professional trader in the stock market can control with the same amount of cash.

Many observers were astounded that, while stock index futures margins were increased temporarily in the wake of the October 1987 break, they were soon again lowered, so that margins were lower in October of 1989 than they were in October of 1987. Futures margins were 3.6 percent at the opening on Monday, October 19, 1987. The futures markets raised them to above 12 percent the following week, but then allowed them to drift back down so that at the opening on October 13, 1989 -- the day the market dropped 190 points -- they were only 2.2 percent.

Today margins on the S&P 500 futures contract are only about 4 percent, which means that a decline of just 4 percent (about 120 Dow Jones points) faces a futures trader with a choice: he either has to double his original margin simply to hold an existing position or sell out, which could put more pressure on a falling market.

A consequence of low futures margins is that during market downdrafts, when the system is most in need of liquidity, futures exchanges are forced to restrict liquidity through increased margin requirements because margins have been set so low. This is precisely the opposite of what should occur: during emergencies it is critical to pump liquidity into the system. Indeed, Chairman Greenspan testified before this Committee that during last October's mini-crash he was "shaken" at the prospect of increasing margins at a time when liquidity was critical.

Let me mention one related point. Our 1987 Task Force Report showed conclusively that a mere handful of firms created enormous selling pressure in Chicago that swept back to New York markets. For example, on October 19 three firms in the futures market accounted for the equivalent of $2.8 billion in stock sales. In the futures market the top 10 sellers accounted for sales equivalent to $5 billion, roughly 50 percent of the non-market maker total volume.

Low futures margins contribute to this ability of a small number of traders to concentrate enormous buying and selling pressure on the stock market.

Disjointed Clearance and Settlement Systems. The most disturbing consequence of major market disruptions is the risk they pose to the entire financial system, especially through the clearance and settlement process. For example, after the October 1987 break, the clearance and settlement system fell over six hours behind its normal payment times, with over $1.5 billion owed to investment houses. Had these funds been missing for any significantly longer time, it could have unleashed a chain reaction of events spreading losses through the payments system.

The Presidential Task Force concluded that the prospect of clearinghouse failures reduced the willingness of lenders to finance market participants, leading to "a crisis of confidence [that] raised the specter of a full-scale financial system breakdown." To reduce the possibility of financial gridlock, we need to have a single regulator for the "one market" who can facilitate coordination of intermarket clearance and settlement systems. Little effective coordination has occurred in the almost three years since the 1987 market break. While legislation is pending in both the Senate and House to help address these systems, a single regulator would obviously help accelerate the coordination process.

Evasion of Short Selling Restrictions. For over 50 years the securities laws have restricted bear raiders like the 1920s' Jessie Livermore from selling short in declining markets. The purpose of these restrictions is to prevent "gunning" the market, which drives down the market and leaves the individual investor helpless. However, a concerted selling effort in the futures market can completely undermine the short selling restriction -- and in fact, because of low futures margins, can accelerate the stock market downdraft. Again, it is critical to harmonize these intermarket rules to prevent traders from using one market to evade restrictions in another market.

Uncoordinated Circuit Breakers. Some progress has been made to coordinate circuit breakers in stock and stock index futures markets, and discussions are continuing within the President's Working Group on Financial Markets. Nevertheless, more can and should be done. Fundamental disagreements continue to exist between markets and their regulators over the appropriate kinds of circuit breakers.

In short, fragmented regulation has impeded progress on the coordination of these fundamental intermarket mechanisms. We believe one regulator with appropriate authority could accelerate progress substantially towards the harmonized regulation we need to address the problem of major market disruptions. One regulator is what every other country with important trading in these instruments has -- the United Kingdom, Japan, and France.

Ineffective Intermarket Enforcement

Another problem created by regulatory fragmentation involves intermarket enforcement.

With two different regulators, it is sometimes hard to prevent manipulation and fraud in transactions between the stock and futures markets. In particular, it is extremely difficult to detect intermarket "frontrunning," where a trader trades ahead of his client in one market knowing that the client's trade will drive a linked market in a particular direction. In fact, at this time there is not even a universally accepted definition of illegal frontrunning in the cross-market context. The current fragmented regulatory system is an open invitation for intermarket manipulation.

Barriers to Innovation

Apart from major market disruptions and intermarket enforcement, regulatory fragmentation also is creating a serious impediment to innovation. This was not always true -- in the past, fragmented regulation sometimes promoted innovation. Competition between Chicago and New York markets spurred new product development, while the practices of different regulators often promoted diversity, experimentation, and creativity.

But regulatory competition can also cause jurisdictional squabbles that can strangle innovation. This is precisely what happened to Index Participation Certificates, which litigation, prompted by the "exclusivity clause" of the Commodity Exchange Act, has prevented from trading in the United States.

With the globalization of financial markets, other countries have provided us all the regulatory competition we need. We can no longer afford jurisdictional conflicts that stifle innovation at home and drive important business away from U.S. markets.

The Administration's Proposal

To remedy these problems the Administration has proposed the "Capital Markets Competition, Stability, and Fairness Act of 1990." The bill contains three key provisions. First, it transfers the authority to regulate stock index futures from the CFTC to the SEC. In order to minimize disruptions to market participants, the SEC will operate under the basic framework of the Commodity Exchange Act, augmented with key enforcement and antifraud provisions from the securities laws. In addition, the SEC would have to consider the sufficiency of any existing CFTC rules as well as the views of the CFTC before adopting its own rules regarding stock index futures. Moreover, in designating contract markets for stock index futures, the SEC would have to consider the fair and efficient operation of the stock index futures market and the maintenance of fair and orderly markets in underlying securities.

Taken as a whole, these provisions will unify SEC regulation of the "one market" of stocks, stock options, and stock index futures in the least disruptive manner. This will enhance coordination of key intermarket issues such as margins, circuit breakers, enforcement, and clearance and settlement.

Second, to enhance the safety and soundness of the financial system, the bill gives the SEC oversight authority over the futures exchanges' ability to set margins on stock index futures. The exchanges would still have the flexibility to initiate margin changes, and the statute would not require minimum margins levels, which would be left to regulatory discretion. This is similar to the SEC's current margin authority over stock options.

The result would be that, for the first time since stock index futures began trading in 1982, the federal government would have prudential oversight authority over margins on all stock and stock derivative products. This is crucial to the protection of the integrity of the nation's financial system.

Third, the bill modifies the "exclusivity clause" of the Commodity Exchange Act to end costly and anticompetitive legal disputes over what constitutes a "futures contract." Hybrid equity securities like Index Participation Certificates could trade in both the futures markets (under the framework of the Commodity Exchange Act) and the securities markets (under the securities laws). Institutional swaps would similarly be excepted from exclusive CFTC jurisdiction under limited circumstances. The bill would also allow the CFTC to exempt other financial instruments under certain conditions.

To facilitate transition, the bill does not take effect until 90 days after enactment, leaving time for the SEC, CFTC, and stock index futures markets to adjust. Persons, contract markets and futures associations registered under the Commodity Exchange Act would be deemed to be registered with the SEC on the effective date, and rules and interpretations of the Commodity Exchange Act would continue in effect. To take advantage of economies of scale, the SEC could enter into cooperative agreements with the CFTC to administer reparations proceedings under the Commodity Exchange Act.

Finally, the bill requires the SEC to report to Congress within 18 months on any additional modifications that are necessary for the efficient regulation of the "one market" of stocks, stock options, and stock index futures.

Conclusion

In sum, we believe the Administration's proposal will accomplish the two major purposes we have in mind. The first is to reduce both the likelihood of major market disruptions and the severity of their consequences. The second is to create a market environment that rekindles the interest of the individual investor.

Furthermore, the Administration's proposal is not the proverbial "camel's nose under the tent." The way markets are now functioning makes no further shifts in regulatory jurisdiction necessary -- not Treasury bond futures to the SEC, not a full merger of the SEC and CFTC. I will oppose more sweeping changes to CFTC authority if the Administration's bill passes in its present form.

Would the CFTC be rendered a less effective regulatory body if the bill passes? No. The CFTC would be able to concentrate its expertise on the more traditional agricultural and financial futures products that have long been the core of its jurisdiction. Indeed, our proposal would have minimal effect on the CFTC because stock index futures represent less than 10 percent of the futures volume under CFTC jurisdiction.

In fact, I believe moving jurisdiction over stock index futures to the SEC makes it more likely the CFTC will survive as an independent agency. Further episodes of severe market disruptions could build pressure to merge the CFTC and SEC, as proposed in the recently introduced Glickman-Eckart bill in the House of Representatives.

Concerns that our bill would strangle stock index futures also are unfounded. I expect the changes we propose would increase investor confidence in the stock index futures markets and would attract the interest of investors who currently do not use these instruments.

What impact would our proposal have on the individual farmer and the agricultural community in general? None whatsoever. Stock index futures simply have no relation to agricultural products or agricultural futures.

Finally, opponents of the bill have tried to characterize these issues as nothing more than a turf fight between government agencies or congressional committees, or a regional battle between financial centers. Turf is not the issue. Nor is it a geographical battle between Chicago and New York. In fact, some of the largest traders on the futures exchanges are New York investment houses. The Treasury Department comes to this issue with no particular parochial perspective. Our sole objective is sound public policy -- how best to reduce the likelihood of violent market disruptions and position our markets for continued leadership in the face of mounting competition around the world.

Moreover, let me emphasize that the problems I have described do not come from the CFTC or SEC. These regulators are doing a good job under impossible circumstances -- trying to administer a system of regulation that simply is not in concert with the "one market" reality that exists today. It is unfair to expect them to regulate markets effectively without the proper tools to do so. Our concern, as I have explained, is the few but critical intermarket issues that are slipping through the regulatory cracks. Unless properly coordinated through a coherent regulatory structure, these few issues pose a serious risk to the financial system.

For the reasons I have outlined, I believe the need to adopt the legislation we have proposed is urgent.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions the Committee may have.

* * * * *

Senator **Dodd**. Thank you very much, Mr. Secretary, for your statement. You have highlighted the issues very well.

I raised a point with you initially because it is a matter of some concern. A lot of us feel that we're being asked here to engage in what is inevitably going to be a pretty significant battle. There is going to be some blood letting before we're through with this process because of the strong interests that are felt between committees and between Members.

A question that a lot of us have here is why some of these issues just can't be resolved at the executive branch level. Why does it take the heavy hand of legislation coming in to try and resolve matters that frankly ought to be able to be resolved between two responsible agencies doing their job, whether it's enforcement activities, circuit breakers or the cross-marketing issues.

Yet we find ourselves acting as a referee between the SEC and the CFTC, and frankly I'm not sure we're going to come out of this process as well as you might like us to or I might like us to.

The fundamental threshold question it seems to me is why can't we resolve these issues in the way they ought to be resolved at the executive branch level of agencies, responsible agencies working out their differences?

You've highlighted the facts and the problem, and you're absolutely correct, and Mr. Greenspan has as well. Everyone who seems to focus on this issue understands it, and yet we've got two agencies arguing about jurisdiction, and now we are being asked to jump into the middle of it and resolve it.

Secretary **Brady**. Well, Mr. Chairman, I think you have outlined the situation eloquently. [Laughter.]

And I mean that with all respect. I mean I can't disagree with what you're saying. Unfortunately, I guess this happens from time-to-time and changes in the law are needed in order to breakup the jurisdictional battle if that is what we've got.

The reason why we feel so strongly about it is we don't think it's a geographical or jurisdictional matter. We think that the world is operating as though we have one market and we need one regulator and oversight of margins to be ahead of that market and make sure we have protected the financial system.

I mean I think you've said it very well, but we need legislation.

Senator **Dodd**. Well, it's going to be troublesome as we move forward, and you know that already. We've had good long discussions and you've been tremendously cooperative in coming up and talking to people and trying to lay out the case here, and I happen to agree with you that if something doesn't happen here, we're faced again with an 1987 or 1989, and I think your question is a good one, to recall what occurred that generated those sharp declines.

The problem is you run the risk, and you've said this and I agree with it. We run the risk of having a situation like the market break in 1987 and 1989. This time it may occur on a Monday and not a Friday, where you have a weekend to respond. We may be looking back wondering why we didn't resolve this issue.

My hope would be that in the process as we go forward an effort would be made on both sides. We'll continue to move forward here to see what we can do to work out a solution, but I would hope that the administration might proceed as well to try and resolve some of these questions at your level. We may not be able to politically resolve some of the questions that we've got here before us, but we will try, and that's why we're here. I promise you on that.

Secretary **Brady**. Thank you, Mr. Chairman.

Senator **Dodd**. Let me go back and raise a question that I'm sure you've been asked before by others, but I haven't had the opportunity to hear your response to it.

In March 1988 you were testifying before the House committee that has jurisdiction over securities, and you were asked the question of jurisdiction over stock index futures and whether or not it should be transferred to the SEC, and to quote you, you said: "It just was not needed." That was your statement in March 1988.

Bob Glauber, who at the time served as the Executive Director of your Task Force, stated that the SEC in his words, and I quote him: "didn't have the expertise to take on the responsibility."

He said, "Congress should just give margin authority for stock index futures to the Federal Reserve."

I wonder if you might tell us why the change of position from the March 1988 testimony.

CHANGE IN POSITION SINCE MARCH 1988 TESTIMONY

Secretary **Brandy**. I would be glad to, Senator Dodd, because I had the hope, which you expressed in your opening statement, that these things could be worked out, that the problem was so clear and so obvious that the day of geographical separation of markets, from London and Tokyo and more parochially in the United States between Chicago and New York, was a day of the past, that these markets were operated in the air on computers, stock quotes every half hour, and TV channels dedicated to bringing information to the public. It was so clear that we had one market that we would not have to do what we are doing today.

I am very reluctant, to be honest with you, to come before you and other members of the committee asking for change at this time. I had hoped for better. Frankly, that hasn't happened, and I think that in view of the risk to the system and the fact that we have lost the support, interest and care of the individual investor who built this country—the statistics are probably right that he is no longer the vital factor in this market, but I submit that if the individual investor gets the idea that it's a system created for the big guy, which he doesn't understand, he will fear the system and won't be part of it—we are asking for trouble and our markets will go overseas.

So all of those things have led me to the position where I now think it's time for a change. I'm sorry, I had hoped for better in 1988. It didn't happen. So let's move on.

Senator **Dodd**. If, however, you go back to Bob Glaubee's statement who said, well, possibly the Fed could do that in light of what they also do with stocks, would that be satisfactory to you? Is that a significant enough improvement that is minimizes the threat that you've just described eloquently?

Secretary **Brady**. Well, Senator Dodd, this testimony which we have before you was designed to tell what we think the best soluton to the problem is. I understand that we won't get everything in the legislation, but I would not want to comment at this time on what a second-best solution is. I think this is the best solution in line with what we have as one market.

Senator **Dodd**. By the way, I should let you know, Mr. Secretary, in the midst of your testimony the stock market reached an historic high——[Laughter.] Of 2952, up 19 points today. Now I don't want to say what has happened in the last 15 minutes or so.

Secretary **Brady**. I'm on your team. I hope it keeps going.

Senator **Dodd**. I just received that note, and I though you would like to know that, at 2:45.

Secretary **Brady**. Thank you.

Senator **Dodd**. Senator Heinz.

Senator **Heinz**. Mr. Chairman, thank you.

Mr. Secretary, in listening to your testimony I have to come to the conclusion that not much has changed in 2½ years since the Brady Commission report except you've got a different job. You're wearing the same tie. That's the same. [Laughter.]

Senator **Dodd**. He's Irish.

Senator **Heinz**. In your testimony today you state, to paraphrase your testimony, that margins are not coordinated across markets, that circuit breakers are not coordinated across markets, that clearance and settlement systems are not coordinated across markets, that enforcement of intermarket trading abuses is not coordinated across markets and that short selling practices are not coordinated across markets.

So it sounds like when it comes to the word "coordination" at least we have a very long way to go. Is there any reason we shouldn't conclude that based on your testimony and what I have just described that one would have to say that the Working Groups that has been ongoing now for better than 2 years really isn't working to address and resolve and solve these intermarket issues?

Secretary **Brady**. Well, the answer to your question is no, but let me just say the Working Group has attempted to do its job. It's just that inertia or structural blocks in the way we've got the system constructed at this point in time won't let them let go. They each have their own particular views, and that is why, as I said to Senator Dodd, I'm sorry to say, I'm back here asking for a change, but that's the way we feel now and we feel strongly about it.

Senator **Heinz**. Now going back to a question that Senator Dodd touched on where we have this dispute between the CFTC and the SEC where the CFTC doesn't want to yield any of its jurisdiction even though it's 5 percent of their volume when it comes to stock index futures, suppose Congress is unable to address the issue in anything like the way the administration has proposed? What are you options at that point? Are we just left with the existing fragmented and clearly dangerous system, or are there some options that you can pursue on your own that might not be as satisfactory, but that you could pursue unilaterally as executive branch initiatives, or are we just stuck with the current system?

Secretary **Brady**. Well, Senator Heinz, I don't have any options in my back pocket that would do to replace what we've asked for here today. I simply think our bill has to be enacted, and in the meantime we'll do the best we can but, you know, what else would we do? Continue to speak out and hope that common sense prevails. The world has changed. I mean the world does change. Look what's going on in the Soviet Union. Things are different. We've got one market now and we ought to regulate it like one market. We ought to take notice of what is happening.

Senator HEINZ. So this is not like the S&L situation where you can blame a considerable part of the problem on the regulators, particularly the State regulators who didn't regulate at all in Texas and California.

Secretary BRADY. Well, all I can say——

Senator HEINZ. You are telling us, Congress, look, if you don't act, we're got our hands tied and we can't do anything and there won't be a mechanism to solve these problems, and if something comes apart, don't blame Nick Brady and George Bush.

Secretary BRADY. Well, you put it well. I mean I—[Laughter.]

Frankly, this statement is a strong statement, Senator Heinz. I'm not giving to making strong statements, but I want to be on the record on this issue. This is how somebody who has had 30 years in this business feels, and I'm trying to be evenhanded and put the information out in a way that everybody can understand, but I think the situation is clear that a change is needed.

Senator HEINZ. Now let me ask you this. We had a panel yesterday, a very broad-based panel, and there was total agreement among the members of that panel which represented corporations, represented exchanges, represented people who dealt in securities, people who were advisers, people who had interests in pension funds, people who were engaged in doing stock index arbitrage that not only are the markets for stocks, stock options, and stock futures in fact one market, but that there has been, because of the crash of 1987 and 1989 decreasing investor confidence that is hurting not only the stock market, but the future market.

CHANGE IN VOLUME BETWEEN 1987 AND NOW

And in relative terms how does the volume of the stock index futures market trading today compare with the volume before the crash in 1987? Is the volume higher, the same or considerably lower?

Secretary BRADY. I'll try to give you that statistic in 1 minute. I know that the dollar volume in Chicago and New York is roughly equivalent one to the other, but I can't give you—maybe I can provide that.

Senator HEINZ. I remember that before the crash the volume in Chicago was a multiple or two higher than what it was in New York.

Secretary BRADY. That's correct.

Senator HEINZ. If my memory is correct, and I doubt that it is, then there has been a tremendous decline in stock future volume in Chicago around futures markets.

Secretary BRADY. The figures I'm being given are that the volume is down 17 percent for stocks and down 35 percent for futures.

Senator HEINZ. Even today.

Secretary BRADY. Yes.

Senator **Heinz**. Thirty-five percent. If there was another crash would you anticipate that the volume would drop off still further both in futures and in other derivative products?

Secretary **Brady**. Well, I would have to think so, Senator Heinz. I mean my mind always goes back to the individual investor because the big guy can take care of himself. I don't have any worry about him. They've got a big load of staff and thousands of people working to help them.

What is an individual investor supposed to think when he sees a 500 point drop? He doesn't understand every in and out of a 500 point or a 190 point drop. He doesn't understand every in and out of the market. He just understands this isn't the place that I want to put my money. And if we've got a market in this country where the individual investor doesn't feel comfortable putting his money, even if he isn't the biggest investor, in my mind something is wrong and it ought to be fixed.

Senator **Heinz**. By the same token if investor confidence were improved, wouldn't it be logical that if the investor saw that there was consistent regulation, that there was a regulatory scheme of stocks and their derivative products that made sense, that if there was that return of investor confidence, that it would help the volumes in both the stock market and the futures market?

Secretary **Brady**. I think so. I mean I don't talk to economists and professors on this subject. I'm sorry. I talk to the people that sell stocks to people, people in regional offices around the country. They are the people that know why people do and don't buy stocks, and they tell you that the individual investor thinks the system is stacked against him, he is disillusioned, he doesn't like wild swings in the markets. So obviously if we can bring some sense to this market and get rid of, not volatility, but unbelievably disconnected spikes in the market both up and down, he"ll come back. He believes in America and he believes in America's companies.

Senator **Heinz**. Mr. Chairman, I would just like to make an observation. It's clear from the figures that the Secretary has provided that the individual investor who you might call a consumer of financial services is boycotting the market. That market is boycotted to the tune of about 17 percent in volume versus 1987 in the stock market and 35 percent in volume with respect to the futures market.

My guess is that more and more consumers will engage in this boycott to the detriment of the country and to the detriment of both the stock market and the future market, and that that's really what is going on. We have a consumer boycott that is getting bigger and not smaller, and that is bad for this country.

So I hope we can find a way out of this very difficult situation that we find ourselves in.

Thank you, Mr. Chairman.

Senator **Dodd**. Thank you, Senator Heinz.

Senator D'Amato.

Senator **D'Amato**. Mr. Secretary, you raised the question I think three or four times in your remarks, does anyone remember what caused the various drops in the market starting in 1987 through 1989 on the four occasions that you cited.

That has really been, at least to this Senator, a question that has never really been answered. For example, in testimony that we've had from yourself and from others we raised a number of issues, one being the volatility of the market because of the very small requirements on the margin that is required in Chicago.

No one really came out, and some may have suggested that there may have been a correlation, but then it seemed to me that the question of the index arbitrage and the computerized trading and what the impact that practice had, and indeed a number of the investment houses voluntarily suspended that practice, and just about all of them at one point in time, and they did that voluntarily, and a number of leading members of those houses told me that notwithstanding it meant a loss of profits to them if they had undertaken it, and they thought it was the right thing to do to stop this volatility. And one at a time we saw them come back in, and now virtually they are all in.

So my question is what impact, if any, does the practice of program trading tie to this index arbitrage and stock index future trading, what does that play, and if indeed we were to have one regulator, say in this case for argument's sake the SEC, absent dealing with that I think fundamental problem, and I agree with Senator Heinz that investors have lost confidence, and I may also suggest to the consternation of my friends at Wall Street that they may be precipitating this for profit motives. They way they wheel and deal on those trades, they get in and out, and the little guy is left holding the bag.

Now if we give the authority to the SEC and they can do something as it relates to the margins in Chicago, is that going to take care of the kind of swings, the violent swings and gyrations that we see that are frightening people?

Secretray **Brady**. Senator D'Amato, to word volatility in my mind is a word that has crept into this discussion that should be there, but it's not the major problem as far as I'm concerned. I think the thing we should be looking at is major market disruptions. I have used the example of the cardiogram where you've got volatility. The guy's heart beats and that's normal, but when you get the wild swings like that, that's when the doctor runs into the room, and that's what we should be cencentrating on.

I think that this legislation that we have put forward would do a great deal in the absence of major news events. I'm not predicting that there won't be economic events that will make a difference, but what I'm saying is that the events that you can't remember producing these wild spikes in the market, I think that this legislation will help to make sure we don't get that.

Senator **D'Amato**. Well, what about the computerized trading? What role, if any, does that play?

COMPUTERIZED TRADING

Secretray **Brady**. Well, I think the computerized trading is part of the link between Chicago and New York, and frankly that link should exist so that the two markets can exist. I don't think that's the problem. We've heard at lot about program trading, but it's only the speed at which program trading takes place that we want to deal with. In other words, to have it continue in the sense of the cardiogram like this is all right. What we are trying to do is to stop it from accumulating on one side of the market and causing these wild spikes and declines.

Senator D'AMATO. Mr. Secretary, let me suggest absent there being any empirical evidence, and there has not been any, and a number of those who oppose the administration's position have stated that they don't see any empirical evidence that suggest that the regulation or lack of regulation at CFTC has brought this situation about.

It would appear to me, and I say this after having heard many, many witnesses come in, that there are two problems. No. 1 is a lack of adequate margin, and I've heard the call for the fact that that might damage liquidity when you need it on the Chicago side, but it would seem to me that there may be some very balanced answers to that, but there is a problem there.

No. 2, I don't understand how we can continue to have this practice of program trading, which isn't benefiting the customers one iota. The big firms are ripping off a little point here as the result of this linkage, and I don't understand how we say well, we want this linkage, but we're not going to stop the computerized trading.

You've got your friends down there and they tell you what's happening, and they've told me off the record, and they are making millions that way. It was one of the biggest profit gainers for lots of the inside houses, and yet at one point they stopped. Now why did they stop? Because they said they felf that it contributed to the disruption, whether you want to call it volatility or not, the wild gyrations of the market, and yet they are back in. Now why doesn't the SEC do something as it relates to that?

Secretary BRADY. Well, I think, Senator D'Amato, we are talking about the same problem but perhaps from a slightly different perspective. I think program trading is not the main problem. Program trading is the vehicle by which the connection between the Chicago futures market and the New York stock market takes place, and we think that that connection has got to exist.

If you kill program trading, the futures market in Chicago would nearly stop because that's the way the volume goes back and forth, and we are not advocating that. What we are advocating is a change whereby this one market that is linked by arbitrage through program trading is regulated by one agency.

Senator D'AMATO. Well, when a guy can come in and leverage the way he does, and I don't know what the SEC is going to do different if you have the program trading except maybe increase those margins, and you could probably do it without this legislation, as the chairman has suggested, as Senator Dodd has suggested.

It just seems to me that maybe what the administration is doing is having its cake and eating it, and I don't mean because you can say look, we warned you fellows about this.

So without raising the margins in Chicago, which you could do without having this kind of legislation, and permitting this kind of thing to take place, which is an aberration, it's not driven by the market, it's driven by a series of events where people have a opportunity to come in and make a quick buck.

Now that's what is happening, and they make it because they trade millions and millions of shares and they get a little point on the thing, a half a point, a quarter of a point, and that is what is driving it, and there is nobody there to support that market when there are huge volumes being traded. Everyone is in basically on the same kind of program. All the houses start to do it, and so the little guy winds up getting clipped.

Now I don't understand how this proposal is going to change that basic underlying problem, and as far as this Senator is concerned, the computerized trading which is permitted now is as much of the problem and is exacerbated possibly as a result of low margins in Chicago, and maybe you've got to get those margins up somewhat and it won't be quite as profitable to do it, but it seems to me that that exacerbates the problem and we're afraid to take on these guys. And if they stopped once, they knew something was wrong, but one guy isn't going to give up profits if he sees the next investment house making it and the third one and the fourth one and that's what is taking place.

I've gone beyond my time and I thank the Chair.

Senator DODD. Thank you very much.

Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

In your opening statement you propounded a series of questions, does anybody remember what caused these various drops.

Regarding the October 1987 crash of 508 points, it seems to me I recall that the decline was prompted by a Ways and Means press release that a tax increase was being contemplated. I must say I would hope that history is not going to be repeated. [Laughter.]

But let me go back in a sense to a question that my friend——

Senator DODD. It just went up today, an historic high. [Laughter.]

Senator ROTH. Wait until the news comes out tomorrow.

But, again, I would like to ask you, Mr. Secretary, and I hope you're right, but why do you believe that the passage of this legislation will cause the small investor to return to the market?

As I recall, one of your predecessors as Secretary of Treasury said that any small private investor who invests in the market is a fool. You not only have the question of these drops, but every day you have the volatility for several hours of stocks going up and down and you have the problem of program trading, the big investor, the managed programs of pensions and mutual funds.

RETURN OF THE SMALL INVESTOR

Do you really thing that this legislation will return the small investor to the market?

Secretary BRADY. Yes, I do. I think the small investor is preplexed, put off, disillusioned and fed up with the kind of thing that you've just put your finger on, and I think that if we propose a regulatory scheme in this country that is one that recognizes the way the markets operate today, one market, not geographically separated, but linked through the electron beam and the computers and instantaneous information, if we propose regulation that recognizes that we are not talking about geographical or turf differences, that there is one market, which this report concluded and it has never been argued with, I think we will see some change in the major market disruptions.

I want to keep saying again volatility is not what we are after. Volatility is the heartbeat of the market. We are not worried about that. We are worried about the spike that brings the doctors and nurses into the room. That's what drives the average investor out. When he buys the stock on Friday and he sees the market go down 500 points on Monday for reasons that we can barely remember, he thinks this is a bum place to put his money and he is plenty smart. He will come back.

Senator ROTH. Let me ask you a further question. How will the transfer of equity futures jurisdiction to the SEC remedy this problem I think of what you call market disruption?

Secretary BRADY. Well, Senator, my feeling about that, strongly held, is that when you have a market that is one market, you ought to have one regulator. It's done in Japan, it's done in England and it ought to be done in the United States.

Senator ROTH. But will that, even though you have one market, will that in and of itself remedy the problem of market disruptions?

Secretary BRADY. I think it will. I can't promise you that, even if we made this change, we won't have another market disruption based on an economic event, but the thing we want to cure is self-manufactured destruction. We are shooting ourself in the foot, and that is what we are trying to cure.

Senator ROTH. Do you think the program trading in any way exacerbates the spikes you talk about?

Secretary BRADY. We are not in opposition to program trading and its sister, index arbitrage, which, if you think about the markets in Chicago and New York is the cross-link between those two markets, Index arbitrage gets carried out by use of the device called program trading, which simply because of the use of computers allows for a huge amount of transactions to take place in a short period of time.

We are not trying to shutdown the Chicago markets. Program trading is vital to the Chicago markets. They need that link, and we are not trying to stop it. We are trying to stop the accumulation of orders, which may come through program trading, which becomes one sided because of the fact that our markets now are linked and there is no common regulation between the two.

Senator ROTH. My time is up. Thank you.

Senator DODD. Thank you very much, Senator Roth.

Senator Dixon.

Senator DIXON. Mr. Secretary, I wanted to talk to you a little bit about the Commodity Futures Trading Commission. Your legislation recommends transferring stock index futures from the CFTC to the SEC and some other things. I think it's fair to say by implication you're suggesting some lack of competence in the CFTC, and one of your former colleagues in the U.S. Senate was here as the lead-off with us and essentially said well, the CFTC is a political dumping ground. That was his first reason, and he gave three, and I want to go over those three with you about why we oughtn't to leave this responsibility in CFTC.

So I want to first ask you about the Chairperson Wendy L. Gramm, the wife of the distinguished Republican Senator from Texas as to whether you think she would be representative of that kind of a politician in a political dumping ground that ought not to be trusted with the future of America. What is you view of Wendy Gramm? [Laughter.]

Senator **Dodd**. We won't say a word to Phil. We'll keep this quiet. [Laughter.]

Senator **Dixon**. Yes, this is not going to get out.

Senator **Heinz**. It's just between us. [Laughter.]

Secretary **Brady**. I don't mean to be captious, Senator Dixon, but I will only point out that the fellow to whom you refer served longer with you than he did with me, and he was in your party. So maybe you'll want to comment on his feelings.

But, second, with regard to Wendy Gramm, obviously I have confidence in Wendy Gramm. To the extent that I followed her statements, I disagree with them, with how this problem ought to be solved.

I pointed out, I think while you were out of the room, that this proposal that we are putting forward is a proposal that is backed by the Bush administration, and I'll leave it at that.

Senator **Dixon**. But you are satisfied about the fact that the President of the United States, whom you support, sent us the name of Wendy Gramm and asked for her confirmation as Chairperson of the Commodity Futures Trading Commission, and you consider her a qualified person?

Secretary **Brady**. Absolutely, I'm the one in the administration that said that ought to be done.

Senator **Dixon**. Excellent. Then it's your choice as well.

Secretary **Brady**. It is.

Senator **Dixon**. Now Kalo A. Hynaman, the Senator from Kansas, the distinguished lady from Kansas yesterday took pretty serious exception to the comments by Senator Eagleton saying she had a lot of confidence in the member of the commission from Kansas. That name was given to us by the Republican leader of the U.S. Senate.

Secretary **Brady**. Excuse me again, I'm sorry.

Senator **Dixon**. The commissioner on the CFTC from Kansas, that name given to us and recommended to the President by the Republican leader of the U.S. Senate, do you consider that person a competent person?

Secretary **Brady**. Mr. Hynaman?

Senator **Dixon**. Mr. Hynaman.

Secretary **Brady**. I don't know the gentleman. I'm sure he is.

Senator **Dixon**. Now are you aware of the fact that there is an opening right now on the commission for the third Republican?

Secretary **Brady**. I am aware of that.

Senator **Dixon**. And wouldn't it not be in connection with your office an appropriate thing for you to talk to the President of the United States whom you're with on regular occasions and recommend a sound person, a very good regulator, a person who understands this one market you're talking about and knows about stock index futures and put that person on the CFTC? Wouldn't that be all right?

Secretary **Brady**. I would be glad to do that, Senator Dixon.

Senator **Dixon**. Would you do that, and then you would have a competent person there, wouldn't you?

Secretary **Brady**. Yes.

Senator **Dixon**. Now then that's No. 1, the dumping ground. I take it you don't think it is a dumping ground then, that the people you have on there are good people and you're going to send us a good person for the third person.

Secretary **Brady**. I would certainly hope so.

Senator **Dixon**. Now then Senator Eagleton says there isn't enough money. I wonder if you know that the bill pending on the floor of the Senate that the administration is holding up increases the sum to $65 million this year and increases it in succeeding years by $25 million a year annually, and this Senator and others are willing to vote for more money. Do you think there is more money needed?

Secretary **Brady**. I think the bill that is before the Senate right now is a good bill, Senator Dixon, and I'm not trying to hold it up. I am trying to improve it just a little bit.

Senator **Dixon**. Thank you. Well, we'll have a dispute about that, but you want to pass the bill there is that is the only thing we can do this year?

Secretary **Brady**. I would like to pass the bill with this amendment.

Senator **Dixon**. But the bill there is an improvement over existing law in your view?

Secretary **Brady**. I think the changes in the bill are good.

Senator **Dixon**. And then, finally, the third point the Senator made as the lead-off witness yesterday said, you know, he said the thing about this is you would have to reauthorize the CFTC every several years. So you would have to come around hat in hand asking for reauthorization. This Senator is willing to make that a permanent commission. Would you like to see the CFTC be a permanent commission? I'm more than delighted to introduce legislation to make that a fact of life.

Secretary **Brady**. Well, I would certainly like to think about it and get back to you about it. I haven't thought about it.

Senator **Dixon**. Well, we just authorized the Securities and Exchange Commission and appropriated again for them. Calendar No. 282, S. 1712 in October of last year, we've just put our imprimatur on that commission again, and I want to say to you, my friend, that if you want to make this a permanent agency, this Senator would like to do so.

So I would say to you in conclusion, Mr. Secretary, that it is in the hands of the administration to make the CFTC every bit as good as the administration wants to see the CFTC be. It's in the hands of the administration to give them the necessary funds, and this Senator will support it, and it's in the hands of the administration to make the CFTC a permanent agency.

And then I have further suggested we could cross-pollinate with one from the CFTC and one from the SEC so they talk every day about this one market that you have discussed with us here today, and I would suggest to you that all of those things, along with the many good things you recommended earlier in the Brady Commission Report would be very salutary and would have I think a benign effect on the market.

I thank you very much for the pleasant time we have spent together here today. [Laughter.]

Senator **Dodd**. Senator Sarbanes.

Senator **Sarbanes**. Well, thank you very much.

Senator **Dodd**. We have a vote on by the way, Mr. Secretary, and I know you are concerned about time.

Senator **Sarbanes**. Mr. Secretary, wouldn't it be fair to say that the Commodity Futures Trading Commission could be composed of three Alan Dixons, men of intellect and integrity and dedication, and you would still favor the proposal that you have before us because you in effect are addressing what you perceive to be a defect in the system of supervision and regulation, and in fact it is the system you have been addressing and not the individual; is that correct?

Secretary **Brady**. That's correct, Senator Sarbanes, and I'm glad you made that distinction, and I would be for Senator Dixon to be on the commission as well.

Senator **Sarbanes**. Pardon?

Secretary **Brady**. I would be for Senator Dixon to be on the commission after it's changed as well.

Senator **Sarbanes**. Well, I think it's very important.

Secretary **Brady**. I'm not being captious. I think you've put your finger right on the point.

Senator **Sarbanes**. Now Senator Eagleton yesterday, for whom I have great respect and admiration, gave some very powerful testimony on the need for a single regulator of the stock and stock option markets, and in fact did it on the basis of his service as a public member of the Chicago Mercantile Exchange. I mean he really spoke on the basis of that experience.

Now I take it your recommendation grows out of, amongst other things, perhaps in particular your Chairmanship of the Presidential Task Force on Market Mechanisms that looked into the stock market crash after October 1987. Would that be correct?

Secretary **Brady**. That's correct, Senator, as well as 30 years in the business.

Senator **Sarbanes**. Now in that report you said or the task force said and I quote:

> Analysis of market behavior during the mid-October break makes clear an important conclusion. From an economic viewpoint what had been traditionally seen as separate markets, the markets for stocks, stock index, futures and stock options are in fact one market. Because stocks, futures and options constitute one market, there must be in place a regulatory structure designed to be consistent with this economic reality. The October market break illustrates that regulatory changes derived from the one market concept are necessary both to reduce the possibility of destructive market breaks and to deal effectively with such episodes should they occur. The guiding objective should be to enhance the integrity and competitiveness of U.S. financial markets.

And I take it that is essentially the rationale of the proposal which the committee is examining here today; would that be correct?

Secretary **Brady**. That is exactly correct.

Senator **Sarbanes**. Now yesterday Senator Dixon cited some quotes of yours, and I don't quite know where they came from, that seemed to imply somehow that you had departed from that position. That is not correct, is it?

Secretary **Brady**. It is not correct.

Senator **Sarbanes**. I'm not quite clear on why this is such a problem. Your proposal would not affect the ability of the firms in Chicago to continue to engage in this broad range of economic activities, would it?

Secretary **Brady**. I don't believe so.

Senator **Sarbanes**. I mean all it would do is bring certain of those activities under the supervision of a different regulator; is that correct?

Secretary **Brady**. That's correct.

Senator **Sarbanes**. And it's your proposition that the equity and the equity derivatives are so closely interrelated that for the system really to be rational and to make sense, the regulation and supervision should be in one place, and you've recommended the SEC; is that correct?

Secretary **Brady**. That's correct.

Senator **Sarbanes**. Now another alternative would be to put it in one place and put it in the CFTC. I mean that would put it in one place, would it not?

Secretary **Brady**. It would put it in one place, but I do not believe it should be in the CFTC, whose principal occupation is agricultural futures. There also are some treasury futures there. Ninety percent of their business is other than stock index futures.

Senator **Sarbanes**. Well, that's generally the view, and there is obviously a great deal of expertise required in supervising and regulating the stock market. In fact, we had two Members of Congress who were here and testified yesterday, who were in the Congress when the CFTC was established in 1974, Senator Eagleton and Congressman Jones. Both said, because at that time we didn't have stock options as a item in the marketplace, and both said that had that issue been put at the time, they have absolutely no doubt that the supervision and regulation of the stock options would have been put with the SEC where the supervision and regulation of stocks was then present.

Secretary **Brady**. I'm sure that would have been the case, too.

Senator **Sarbanes**. And it's your view today that arrangement that makes the most sense; is that correct?

Secretary **Brady**. That's correct.

Senator **Sarbanes**. Would you say that in a sense this function in the current arrangement of the system carries with it a very high risk of inadequate supervision, inadequate regulation and inadequate ability to respond at a time of crisis which heightens the risk we are running to the stability and integrity of our financial system?

Secretary **Brady**. I would agree with that statement. I would only say one thing more. I was asked to come down in 1987 on Tuesday, the day after the crash, and the thing that I remember the most is the lack of coordination and understanding of how these markets are linked together. It's really the fundamental reason why this report exists.

Senator **Sarbanes**. In fact, at the time of crisis it's so essential to move quickly that even with the best coordination the system is probably not going to be adequate to respond. Isn't there a risk that that would be the case?

Secretary **Brady**. Even with these changes that we've suggested?

Senator **Sarbanes**. No, without these changes, but even with an emphasis on coordination, working together, consultation and all the rest of it, at a time of crisis and emergency when you have to move so quickly and respond so fast, that that creates again a dysfunction in the system that means your ability to deal with the crisis is not what it ought to be. It's better if it's all placed in one regulator.

Secretary **Brady**. That is correct.

Senator **Sarbanes**. Thank you very much, Mr. Chairman.

Senator **Dodd**. Thank you, Senator Sarbanes.

I want to go quickly to Senator Simon.

Senator **Simon**. Just one quick comment.

First, I visited with one of the SEC Commissioners, who I saw quoted in a newspaper, and asked him what he thought, and he suggested this move would not be in the interests of the financial markets. This is an SEC Commissioner.

Second, it seems to me your whole case is premised on this. You go back to the three events up to 1955 and the extremes in the volatility. Then you jump to 1987, 1988 and 1989, and you say this is the futures market that has caused this.

Now there is one other thing that happened along there, and that is computers came into our society in a huge way and program trading did. It seems to me that the evidence is just overwhelming that it is not the futures market that is causing the extremes in volatility, but it is the program trading that is doing that.

Senator **Dodd**. We need to make this pretty quick because we are going to miss a vote here.

Secretary **Brady**. Senator Simon, my point with regard to the statistical evidence we set forth in the testimony is that in the previous 40 years the big market jumps, and we used 6 percent as the threshold, were based on the invasion of France, the encirclement of American troops at Dunkirk, and a President's heart attack.

Since 1982, at which time stock index futures started trading, similar drops in the market are caused by events that nobody in this room can remember, and I'm frank to say I can't either. So I think there is a big difference, and something is wrong.

Senator **Dodd**. They weren't created by it. They exacerbated it and complicated it. There is a distinction between creating the problem and complicating the problem.

Senator **Simon**. But you're assuming it's the futures that have caused that, and I think it may be program trading that caused it.

Secretary **Brady**. I dont think, sir, that the Chicago futures markets want to see the end of program trading.

Senator **Dodd**. Mr. Secretary, let me thank you for being here today. I had originally thought I would ask you to wait and come back, but I'm going to make a request of you and I realize it's impossible for you to respond definitively at this moment, but we have another day on the 24th of this month. I know I have about 10 or 15 other different questions that I could submit in writing to you, but others may want to be here to continue some of the questioning. This is a very important effort. You've asked us to make it a priority, and we are.

I would make the request that on that day of the 24th if you could give us another hour without any opening statements, just to come back in for purposes of terminating the questioning, it would be of great help to us. We have other witnesses that day as well.

But today we will let you go rather than having you hang around another 20 minutes while we come back. That's the exchange I offer.

Secretary **Brady**. I'm sure I can make it Senator Dodd. You understand I'm in the middle of these budget negotiations and am responsible for a part of it.

Senator **Dodd**. I thank you, Mr. Secretary. We all thank you.

The committee stands adjourned.

[The committee adjourned at 3:55 p.m., subject to the call of the Chair.]

[Response to written questions follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATORS GARN AND HEINZ FROM NICHOLAS F. BRADY

Q. 1. An important issue raised by the Administration's bill which hasn't gotten that much attention involves the currency and interest rate swap markets. Swaps are typically customized agreements entered into between two banks or other institutional market participants designed to hedge their respective exposures to foreign exchange or interest rate risk. They are not instruments which are marketed or sold to the public. It is also my understanding that the United States plays a dominant role in the international swap market.

The Administration's bill specifically carves out swaps from the jurisdiction of the CFTC. Could you please explain the reasons for this approach? I thought that it was Congress' intent, as evidenced by legislative history accompanying the creation of the CFTC, not to regulate the swap market, and that the Commodity Exchange Act did not reach these kinds of swap arrangements.

A. 1. In 1989 the CFTC issued a "Policy Statement on Swap Transactions" creating a non-exclusive safe harbor for swaps meeting certain criteria (54 Fed. Reg. 30694, July 21, 1989). The CFTC believes regulation under the Commodity Exchange Act is unnecessary for swaps having those characteristics. The criteria for safe harbor treatment are generally that: (1) the swaps are individually negotiated between the parties rather than standardized; (2) there is no automatic right of offset; (3) they are not supported by a clearing organization or margin system; (4) they are undertaken in connection with each party's line of business; and (5) they are not marketed to the public.

Confusion and legal uncertainty as to the status of swaps, in spite of the CFTC's effort to clarify their status with the Policy Statement, have convinced us of the need for a statutory exclusion. There are several reasons why the current regulatory scheme is unworkable. First, the Policy Statement does not have the force and effect of an agency rule or interpretation. Even if it did, the Commodity Exchange Act does not expressly grant exemptive authority to the CFTC. As a result, there is some question whether the Policy Statement might be overruled by the courts.

Secondly, the criteria for safe harbor treatment preclude development of a clearing operation and mark-to-market margining procedures that we believe would have a positive impact on safety and soundness of the swaps market. Furthermore, since swap agreements are not amenable to trading on futures exchanges, we believe it is necessary to clarify that standardization of terms can occur free of concern that such standardization will cause such transactions to fall within the coverage of the Commodity Exchange Act. This is particularly important for provisions that represent prudent business practice, such as those that would facilitate a system of margining or more efficient clearing of swap transactions.

Third, the "line of business" requirement in the Policy Statement is unnecessarily restrictive. Our bill proposes instead to exclude swaps that are undertaken in connection with the parties' business (including financial intermediation) or risk hedging activities. The requirement that swaps be undertaken in connection with the parties' business is intended to include within the exception swap agreements entered into by an entity to lower or fix interest or other costs related to the entity's business (such as the cost of fuel for a large hospital).

Finally, the Policy Statement does not refer to other swaps-like instruments, so the status of existing instruments like collars is unclear and the market may be inhibited from developing other swaps-like products in the future.

You correctly point out that the United States plays a dominant role in the institutional swap market. This market is far too important, both to the Nation and to market participants, to continue to allow uncertainty and confusion under the Commodity Exchange Act to inhibit its use and development.

Q. 2. Senator Leahy and others have criticized the Administration's bill as allowing bucket shops for a variety of financial products to flourish without regulation. In fact, Senator Leahy has argued that the Administration's bill will mean that cash-settled U.S. Treasury bond futures could be traded in casinos. I assume the Administration did not intend that there be unwarranted gaps in the regulatory structure. How would you respond to these criticisms?

A. 2. We believe that hypothetical problems raised, such as casino sales of cash-settled Treasury bond futures, could be cured by SEC enforcement action under existing securities laws. We certainly did not intend to create regulatory gaps, and none were identified by the CFTC when it was given the opportunity to comment on our draft proposal. If any inadvertent gaps are discovered, we would be happy to consider any suggestions for clarifying the appropriate language.

THE SEC/CFTC JURISDICTION AND MARGIN

TUESDAY, JULY 24, 1990

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Bond, Heinz, Dodd, Shelby, Gramm, and Sarbanes.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The **Chairman**. Let me invite all in attendance to find seats. And let me welcome our witnesses this morning.

Senator Pressler cannot attend today's hearing. He is very much interested in the subject of this hearing and was scheduled to be here today.

Senator Pressler's father passed away last weekend and he is back home in South Dakota for the funeral. We extend our sympathies to the Senator and his family.

Today, we hold our third hearing on the administration's legislative proposal, the Capital Markets Competition, Stability and Fairness Act of 1990.

Two weeks ago, the committee held 2 days of hearings, during which we heard from supporters of this bill. Earlier this year, the Securities Subcommittee, chaired by Senator Dodd, heard testimony from the President's Working Group on the question of the appropriate scope of jurisdiction between the Securities and Exchange Commission and the Commodity Futures Trading Commission.

This morning's hearing takes on added importance in light of yesterday's market volatility. Two weeks ago, Treasury Secretary Brady testified before the committee that enactment of this bill would be helpful, in his view, in avoiding major market disruption. He described a major market disruption as a period when the markets for stock and stock index futures disconnect with prices spiraling down.

Yesterday, in the first hour-and-a-half of trading, the Dow Jones Industrial Average fell over 100 points, triggering concerns about an even sharper decline. Reports indicated that futures trading, and particularly index arbitrage, were quite heavy during that time. I do not want to speculate about what caused Monday's sharp decline. Nevertheless, yesterday's plunge can only add to concerns about the speed and severity of market drops, and in turn, a possible impact on investor confidence.

If such market declines continue to occur, I think in many cases, they appear to reinforce the perception to individual investors that the markets are controlled by large traders in some fashion, which would be to their detriment as smaller individual investors. And I think anything that has an inhibiting factor in terms of causing small investors to feel that they can't participate or can't participate on an even footing is not a good development for the country.

Not surprisingly, many individual investors have chosen not to participate in a market that they are concerned may be unfair to them. Charles Schwab testified before the committee that since 1987, 25 percent of equity-type investors have withdrawn from the market, and that one-third of individuals who continue to participate in the stock market buy less often and in smaller amounts.

This statistic is consistent with the studies that show that the percentage of publicly traded stocks outstanding held by individuals decreased from 84 percent in 1965 to 55 percent in 1989. Now, obviously, there are a lot of other simultaneous developments going on at the same time that impact on that kind of data.

The witnesses at today's hearing oppose the administration's proposal. I am very interested in their views on whether we should be concerned about the departure of the individual investor from the markets. I'm also interested in our witnesses view on the cause of yesterday's steep market drop.

Finally, to emphasize the importance of the subject before us this morning, this hearing is being held at the full committee level. Nevertheless, recognizing Senator Dodd's chairmanship of the Securities Subcommittee, together with the ranking minority member, Senator Heinz, and their early and continuing interest in this subject, I've asked Senator Dodd to chair this full committee hearing, as he chaired the two earlier hearings on this bill.

And he will be arriving momentarily, as he had another matter that required his attention early this morning. I expect him to arrive at any time.

But let me now yield to Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, thank you. I join you in welcoming today's witnesses, as we continue this set of hearings on the administration's legislation that is aimed at enhancing the safety and the efficiency and the competitiveness of our capital markets.

As those who followed our earlier hearings know, all of the witnesses who have testified, including Secretary Brady, have been unanimous in support of this legislation. But something tells me that that streak is about to end this morning. Of course, no one expects, let alone gets, unanimous support for any legislation, but one of the most important functions of our hearings is to place opposing teams on a common ballfield and see how the witnesses field the questions.

I want to express regret that it wasn't possible to have both LaSalle Street and Wall Street represented at the same table either today or at our previous hearings. And so, in that regard, the committee which usually benefits from that kind of informed debate, has unfortunately struck out.

Mr. Chairman, I don't think that anybody disputes the fact that, from an economic standpoint, the markets for stocks and options and stock index futures, are indeed one market. The administration's legislation is designed to bridge the gap in the regulation of these markets, and I look forward to closing the loop here today with this group of people from the futures markets, and hope that, as a result, we may be able to cross a bridge that, up until now, we've been unable to construct.

The CHAIRMAN. Very good.

Let me call on Senator Dixon, a person with strong and well-known views on this subject.

Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Thank you, Mr. Chairman, Mr. Chairman, today's the third day of hearings on S. 2814, the administration bill known as the "Capital Markets Competition, Stability and Fairness Act of 1990." We have a good group of witnesses before us here, and I look forward to their testimony.

Mr. Chairman, we're here at an interesting time. The New York Stock Exchange closed, yesterday, after losing 56 points. At one point in the morning, it was down over 108 points on the Dow. Now, there may be officials at the Treasury Department rubbing their hands with glee over these figures, based on a perception that the market decline makes the case for Treasury's proposal.

However, unfortunately for Treasury, Mr. Chairman, yesterday's events make the opposite case, providing convincing evidence that Treasury's rationale is fundamentally flawed. The theory behind Treasury's bill is that too low stock index futures margins can contribute to episodes of intraday market disturbances. The fact, Mr. Chairman, is that stock index futures margins are almost 13 percent right now. They're either equivalent to or greater than margins on stock options. They are clearly at prudential levels. The stock market, though, still fell 108 points in less than 2 hours, providing a convincing demonstration of the lack of any link between stock index futures margin levels and stock market disturbances.

The stock market did not decline, yesterday, because of futures margins levels. Rather, the stock market declined based on current news—I've got the papers here—such as disappointing second quarter corporate earnings reports, the headline in yesterday's New York Times, stating that, "In New England, the worst recession in the United States takes hold." Prospects for enactment of a transaction tax, that famous transaction tax that the administration is shopping in every hallway in the heart of the Dirksen and Russell buildings, and talking about all the summit, and whispering about in the halls, while New York fights Chicago, the transaction tax, and a growing consensus that the stock market is currently overvalued.

Now, Mr. Chairman, I don't pretend to be a stock market analyst, and I can't state definitely why the market fell, of course. What I can state, with complete confidence, is that stock index futures market margin levels played absolutely no role, none, in yesterday's stock market down turn. I look forward to exploring that issue and other issues related to the Treasury proposal with the witnesses here this morning.

Now, Mr. Chairman, here's today's New York Times. I want to call attention to the committee. Circuit breakers help index futures recover. Now, that's a consequence of what we've done here as a committee, and working in concert with the markets, with the administration and others. Stocks reflect worries on health of economy. New York Times. Some breathing time after the market plunge and a great article here, talking about the breathing time as a consequence of the circuit breakers.

Here's the Wall Street Journal. What does it say? It says, yesterday Wall Street took its revenge, acting like jilted lovers, investors dumped MacDonald's and other gross stocks, knocking the industrial average down 56.44 in heavy trading.

You know, Mr. Chairman, I just want to make this final remark about this, if I can find the papers. I've remarked before about all these full page ads in the Wall Street Journal, the New York Times, and the Washington Post, cost hundreds of thousands of dollars, put in by Newberger and Berman. And I wondered why I got a letter from them, with a copy of the ad, a letter which they wrote. And now I find out why. I'm a stockholder in Newberger and Berman, and I've got a 177 shares in that company. And I just want to tell them, as a person who hopes to make a profit, I don't like the way they're wasting my money.

The **Chairman**. I have a feeling they got the message.

Senator **Dodd** [presiding]. How's the stock doing?

Senator **Dixon**. It's not doing too bad. [Laughter.]

Senator **Dodd**. Then the letter won't be a real strong letter, I presume, then?

Is my colleague completed with his statement?

Senator **Dixon**. Yes, I think I've vent my spleen.

Senator **Dodd**. All right, OK.

Senator Bond?

OPENING STATEMENT OF SENATOR BOND

Senator **Bond**. Thank you, Mr. Chairman.

We have a number of distinguished witnesses with us today, and we all want to hear their views on this very important issue that's before us. So I don't want to hold up the process, and I will contain my spleen for a little while longer, as a result.

But I do want to point out that I still believe we have a real problem in our markets, and a problem that we need to address. As our full committee chairman said in his introductory remarks, there is a loss of confidence among small investors. It's brought on by a feeling that the small investor can't compete with the big boys, the institutional investors who use program trading and index arbitrage, maybe even portfolio insurance to protect their margins.

Nobody's rubbing their hands in glee about what happened yesterday. W're all delighted that it didn't go any further than it did. Perhaps it had something to do with the fact that the margins on stock index futures were substantially higher thay they were in October 1987 and 1989. In any event, the loss of confidence is bad for our markets, it's bad for our economy.

I do not believe that the bill that is before us today has the necessary support that it needs to move forward. But given the major market breaks that we have seen in recent years, 1987 and 1989, plus the scare we had yesterday, and the resulting loss of confidence in the markets, I really think we need action. I have talked with a lot of people, I've talked to as many of them as I could yesterday, who have the responsibility of trying to entice small investors into the market, and they were saying there was a wholesale condemnation of program trading.

Program trading obviously is not something we are talking about nor could we ban, should we want to, but there is clearly an interrelationship between the markets. The Secretary of the Treasury has pointed out that there are real dangers in the leverage when margins are very low in stock index futures, and I believe that there's sufficient justification been shown for the dangers that can lie in a major market disruption.

We've talked a lot about it. There's been a great deal of rhetoric thrown around on both sides; horror stories advanced on both sides. I hope, today, that we can set some of that rhetoric aside and work together to craft a bill that will enable us to strengthen investor confidence, bring small investors back into the market, and assure the continued health and long term viability of our equity markets, our derivative markets, and the economy, as a whole.

I look forward to hearing the comments of the witnesses today.

Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. Thank you, Senator Bond.

And let me also join my colleagues in welcoming our distinguished panel, especially Leo Melamed, a good friend, and we thank you for your willingness to come in.

I want to say at the outset to all of you here, particularly those of you who are from the Chicago area, everyone of us at this table will share one thing in common, whatever other disagreements we may have. If you're ever in a squabble, there's one fellow on this table you want to have on your side, and that's Alan Dixon. And no one has worked harder or talked to more of us about this issue and what it means to his State and to his constituencies. He has urged that it be handled properly and well.

And I mentioned before, Leo, when I spoke to a group of folks from Chicago, how much Marty Rousseau had done on the House side, and how much Alan has done. It's been a constant issue that Alan has raised with every single one of us here, to see to it that whatever happens here is going to be the right thing for the country. And I just want to express that view. We tease and have some fun up here, but this is serious business. And Alan takes it seriously and has done a tremendous job in bringing to the attention of all of us here, the imporance of this question and how it best ought to be handled.

In hearings 2 weeks ago—and I'm sure all of you had an opportunity to review the testimony in those hearings—we heard from proponents of the legislation offered by the administration, including Secretary Brady, who strongly believes the legislation is necessary to reduce systemic risk and maintain the integrity of capital markets in this country.

Today, of course, we're going to hear from members of the futures industry and the agricultural community, all of whom are opponents of the legislation. And, again, I appreciate your willingness to be here with us.

I want to make a special mention of you, Leo, because this is one of your last opportunitities to testify, at least in your present capacity, before Congress. You'll be leaving the Chicago Mercantile Exchange this year, after an extraordinary career, during which the U.S. futures markets have been the dominant futures markets in the world. That can't be said about a lot of industries in this country, unfortunately, today, but it certainly is true of the futures industry. In no small measure, in my view, that's due to Leo Melamed's work and efforts.

Let me also note that this may be the first time that the Farm Bureau Federation has testified before this committee, although, from time to time, considering some of the legislation we've passed, maybe we needed them here on occasion. I want to give a special welcome to Mr. Kleckner for his willingness to be here, as well.

To all of the witnesses, while you may feel more at home testifying before the Committee on Agriculture, I hope you understand the concerns held by this committee, which has primary responsibility in Congress for the health and competitiveness of the capital markets in this country.

There's been a great deal of discussion about the issue of turf and jurisdiction. At a hearing 2 weeks ago, the point was made that the administration's proposal had been referred to the Committee on Agriculture, suggesting, perhaps, that the Banking Committee's interest in stock index futures may not have the same legitimacy as the Committee on Agriculture.

However, there's no dispute about the linkage between the securities and stock index futures markets. Virtually every study and virtually every witness before this committee in the 14 hearings that we've held on these issues since October 1987 have made that point. And yesterday's activity in the market did nothing to contradict it.

Finally, there was no mincing of words by the Secretary of the Treasury and the Chairman of the Federal Reserve when they appeared before this committee. Chairman Greenspan testified, and I quote him, that he was "shaken" by the events of last October when stock index futures margins were so low that they had to be sharply raised during a time of market stress. Secretary Brady echoed these concerns, and he also expressed broader concerns about the problems of split regulatory jurisdiction over what he views as one market.

The GAO report, released yesterday, says that the regulatory differences between the SEC and the CFTC have undercut their efforts to coordinate responses to intermarket problems. The GAO also observed that the debate over jurisdiction has held up passage of two very important market reform bills: S. 648, the Market Reform bill which was developed in this committee, and S. 1729, the Futures Trading Practices Act developed in the Committee on Agriculture.

In my view, we are reaching a critical point in the legislative session, and we'll have to resolve these issues in some manner. We have to resolve them soon, or risk ending the session without achieving these much needed reforms.

I would say to our panel and to my colleagues, I have a number of questions, as I know they do, for our witnesses this morning. And although I'm not encouraged that we will advance the cause this morning or come any closer to bringing the two sides together, I do want to thank our panel for being here and for their willingness to express their views on what they think is in the best interests of this country.

And, Leo, again, we thank you for being here. We're going to begin with you this morning.

Leo Melamed is the chairman and chief executive officer of the Chicago Mercantile Exchange.

Were the witnesses introduced?

The **Chairman**. No, they've not.

Senator **Dodd**. Well, let me list them for the record.

Karsten Mahlmann is the chairman of the Chicago Board of Trade.

Dean Kleckner, I've mentioned already, president of the American Farm Bureau Federation.

Mr. Morton Lane, president of the Discount Corporation of New York Futures.

Robert Petersen, the president of the National Grain Trade Council.

William Seale, president of the National Association of Futures Trading Advisors.

And Robert Wilmouth, the president and chief executive officer of the National Futures Association.

I think that covers everybody, and I appreciate again your willingness to be here.

Leo, we'll begin with you. And if you could, try to keep your remarks down to 6 minutes or so. I know the statements go a lot longer than that. Every statement will be included in the record in full, so if you emphasize the substance of your statements, we can try and get through all of the testimony in the next 45 minutes or so, and then we'll be able to get into the questions.

STATEMENT OF LEO MELAMED, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHICAGO MERCANTILE EXCHANGE

Mr. **Melamed**. Mr. Chairman, thank you for your kind remarks. Mr. Chairman and members of the committee, thank you for this opportunity to appear before you. I will submit the full written statement of my testimony for the record, as you suggest, and only make a brief opening remark at this time. Accompanying me today is John T. Geldermann, our chairman, and William J. Brodsky, president of the Chicago Mercantile Exchange.

Mr. Chairman, allow me to begin by saying that I find it rather strange that the U.S. Congress would consider extreme structural changes in American markets at the precise historical moment when these markets have demonstrated their unequivocal effectiveness in matters of finance, and achieved an unparalleled triumph for capitalism, for democracy, for a market-driven economy.

I submit that recent events in Eastern Europe and the Soviet Union demonstrate, beyond a shadow of a doubt, that American markets in securities, futures, and options are far superior to a market system whose structure is dependent on the edicts of Government.

Is it not bizarre that at the precise moment when the bust of Lenin is unceremoniously removed from Moscow's city hall, that there are those who would advocate major structural changes in the regulatory or jurisdictional framework of U.S. capital markets.

Mr. Chairman, the markets that developed in the United States over this century are at the epicenter of the cause that toppled the communist order. United States capital markets represent the quintessential reason why the American standard of living, its social structure, its potential for the future, are the very envy of everybody else.

And Mr. Chairman, I would place futures and options very high on the list of American markets. These markets are integral and indispensable to the economic order that demonstrated its supremacy over an inferior economic system. Indeed, what markets better epitomize price determination by virtue of free forces of supply and demand than do the markets of futures and options.

I submit, Mr. Chairman, that the financial futures revolution launched in Chicago in 1972 blazed the trail for much of what has happened in capital markets all over the world. As a consequence of the worldwide acceptance of Chicago markets, they are today utilized by investment bankers and broker dealers, by foreign exchange traders, by Government security dealers, by banks and insurance companies, by pension funds and mutual funds, and corporations and financial institutions of every sort. And our markets have become the model for every other financial center in the world, and now have replicas in London, Paris, Hong Kong, Sydney, Toronto, Singapore, New Zealand, Brazil, Osaka, Zurich, Dublin, Frankfort, and, yes, Tokyo.

Most of the foregoing, Mr. Chairman, occurred under the auspices of the Commodity Future Trading Commission, the CFTC. Do these successes and innovations suggest a failure of the CFTC deserving its removal from oversight over one of the most successful product lines, one that it helped develop? I think not.

Mr. Chairman, we are told that somehow the fact that there are two regulators in the marketplace has been a disservice to the American consumer. Clearly, the facts I have just cited belie this contention. Separation of jurisdictional powers between securities and futures has been one of the most constructive forces in exerting a competitive influence on the private sector, to the benefit of U.S. capital markets as a whole.

We implore that you not change this structure.

Mr. Chairman, we are told that separate market regulators have somehow contributed to investor loss of confidence in the marketplace or that the market volatility allegedly resulting from intermarket trading techniques has turned away the small investor. Such contentions are blatantly wrong and are a disservice to this inquiry. The New York Stock Exchange Panel on market volatility and investor confidence, which recently submitted its report on this very point to the New York Stock Exchange, as well as to the Congress—a panel on which I served—determined that investors are much more concerned with stockbroker honesty, ethics, interest rates, inflation, recession, insider trading and bankruptcies of businesses, than they are about volatility or program trading. Moreover, as most observers know, the shift by the individual investor is not away from the market but rather to the professional market manager. That's where the individual investor has gone and continues to go, a trend that is ongoing.

But, Mr. Chairman, the most preverse argument I've heard for two separate regulators is that it will prevent the next market crash. That, to me, sounds like false advertising. I doubt very much whether the regulatory gap, or whether there are two or one regulators, will prevent a market decline, if one occurs. There are plenty of good reasons--all fundamental—to explain a market decline.

They have to do with corporate profits, with interest rates, inflation, the savings and loan debacle, the budget deficits, and foreign dependency for money. Add to them one more thing—the recent suggestions for a securities transaction tax, which I dare say every financial analyst who has commented on this point, knows that this could be the final straw on a market to send this fragile market downward.

Mr. Chairman, my point is to say that we have achieved an enormous success in this country, one that is followed by the rest of the world. If changes need to be implemented, there need not be extreme structural changes, such as changing regulators.

Thank you very much. I stand ready to answer your questions.

[The complete prepared statement of Leo Melamed follows:]

TESTIMONY

OF

LEO MELAMED

CHAIRMAN OF THE EXECUTIVE COMMITTEE
AND SPECIAL COUNSEL TO THE BOARD

CHICAGO MERCANTILE EXCHANGE

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS

UNITED STATES SENATE

JULY 24, 1990

SUMMARY OF TESTIMONY

Despite our prompt and thorough response to every substantive issue raised by the White House Working Group and the Brady Commission and despite numerous academic studies supporting our views, we are today faced by a piece of legislation founded on five *false* assumptions: (1) that the legitimate issues have not been addressed by the exchanges; (2) that extreme market breaks are a consequence of the regulatory structure; (3) that future stock market crashes can be avoided by a jurisdictional rearrangement; (4) that inter-market trading violations are rampant and cannot be prosecuted under the present regulatory regime; and (5) that somehow investor confidence in the markets has been damaged by virtue of separate regulators.

ARGUMENTS FOR TRANSFER ARE WITHOUT SUBSTANCE

It is claimed that the recent extreme market gyrations would not have occurred, or would have been less extreme, if there had been a single regulator. The claim that a single regulator would have mitigated the market's movement is not supported by the facts.

A second ground for the elimination of the CFTC as a regulator of futures contracts based on securities-type products is the assertion that these futures contracts are functionally equivalent to the securities that underlie them. This argument is groundless. It is exactly like arguing that energy futures should be regulated by the Department of Energy because both relate to energy, or that ocean shipping insurance ought to be regulated by the Maritime Commission because both relate to boats. The fact is that futures trading is a species of insurance. The method by which the product is traded, marketed and regulated is completely different than comparable securities transactions.

Of late, the Treasury has added four additional provocations to justify a jurisdictional transfer: (1) evasion of short-selling restrictions; (2) ineffective inter-market enforcement; (3) barriers to innovation; and (4) clearance and settlement breakdowns.

Treasury fails to recognize that concerted selling in futures markets is illegal and that futures markets impose significant restrictions on the size of positions that any speculator may assume. Treasury fails to recognize that the futures markets have audit trail technology that can easily detect and prevent such conduct. But, the most glaring defect of the argument is that the securities option markets, regulated by the SEC, do not have any short selling restriction nor could they (nor could any futures market) and continue to function effectively.

The claim that the split in regulation has precluded effective prevention of manipulation and fraud in transactions between stock and futures markets has a certain justice to it, but the imperfection has been the consequence of the SEC's failure to require its regulated exchanges to implement audit trail systems and compliance programs on a par with futures exchanges. Futures exchanges maintain accurate large trader reporting systems that permit next-day identification of the members and customers that hold large positions and that have traded. The CME has such information on 85% to 90% of the positions in its S&P 500 contract. The contrast with securities markets is startling.

The argument that the CFTC has been a barrier to innovation is particularly rankling. The SEC vigorously opposed approval of stock index futures by the CFTC. Today, stock index futures are actively traded in Tokyo, Osaka, London, Paris, Singapore, and elsewhere, all following the American model.

The futures exchanges, with CFTC oversight, created contracts in currencies, interest rates, and stock indexes. This financial futures revolution blazed the trail for much of what has since followed in world capital markets. It established that there was a need for a new genre of risk management tools responsive to institutional money management and modern telecommunication technology; it led to the acceptance and integration of futures and options within the infrastructure of the financial establishment; it acted as the crucible of ideas for new off-exchange products; it became the catalyst for the development of futures markets worldwide; and it induced the introduction of risk management as a regime.

Similar products were approved by the SEC for securities exchanges but only after the proved success of their futures market counterparts. The securities industry and the SEC, for the most part, simply copied the innovations created in the futures industry.

The assertion that clearance and settlement systems will benefit from the transfer of jurisdiction to the SEC has no basis in fact. We must not lose sight of the stark distinction between futures exchange clearing systems and securities exchange systems. Futures exchanges settle on a next-day basis rather than the five-business-day basis common in securities systems. Futures markets mark positions to market each day and frequently more than once each day. Futures exchanges operate a no-debt system. There has never been a financial failure related to stock index futures trading.

With respect to CFTC competence, we have spoken at length with legislators who are firmly convinced that the CFTC is not as experienced, nor as firm, nor as knowledgeable as the SEC. These legislators are simply reluctant to trust the CFTC with the sensitive job of regulating financial futures contracts. It seems to us that this is an image problem more than anything else. We have suggested to all who have criticized the CFTC to refrain from repeating generalities, step back from rumors, ignore unsupported editorials and look at the facts. The facts and the record are clear. In every identifiable area of regulation, the CFTC compares favorably with the SEC.

Finally, the notion that somehow separate market regulators have contributed to investor loss of confidence, or that the market volatility allegedly resulting from inter-market trading techniques has turned away the small investor is contrary to the facts. The New York Stock Exchange Panel on Market Volatility and Investor Confidence that recently submitted its report on this very point determined that investors were much more concerned with stock broker honesty and ethics, interest rates, inflation, recession, insider trading, and bankruptcies of business, than they are about volatility or program trading. Moreover, the shift by the individual investor is not away from the market but rather to the professional manager. According to data from the Investment Company Institute, assets in all mutual funds grew from 770 billion dollars at the end of 1987 to over one trillion dollars today. This trend toward professional investment management is of long standing duration and has nothing to do with market regulation by the CFTC or the SEC.

DEFECTS OF ADMINISTRATION'S BILL

The Administration's Bill would do severe injustice to the regulatory structure for futures markets -- America's greatest financial success story. For example, the legislation would:

A. Eliminate, without justification or explanation, all federal regulation of off-exchange trading in financial futures and options;

B. Force self-regulators -- the futures exchanges and the NFA -- to administer overlapping and inevitably inconsistent regulatory requirements, and subject these organizations to the control of two different and sometimes uncooperative regulators;

C. Force registrants, such as introducing brokers, futures commission merchants, commodity advisors and pool operators, to comply with duplicative, potentially contradictory regulatory schemes administered by two different regulators;

D. Create a confused, expensive, and problematic scheme of civil anti-fraud remedies that is far more expansive than any now in existence; and

E. Create uncertainty in the clearing process by subjecting futures clearing houses to regulation by two federal agencies, which will inevitably lead to the imposition of inconsistent requirements and intolerable delay during periods of stress.

MARGIN POLICY

Margin levels at futures exchanges are variously blamed for increasing prices, falling prices, and/or higher volatility levels. Such belief are contrary to the findings of all independent studies. In contrast to securities markets, futures markets maintain a virtual "no-debt" financial system. All futures market positions are marked-to-market on a daily basis, *i.e.*, any value changes in futures positions representing losses must be paid for in cash at least on a daily basis. This critical difference acts as a foundation for many other fundamental differences between the securities markets and the futures markets.

The Brady Report unequivocally concluded that as regards "the intra-market financial performance control aspect of margin," futures margins differ "fundamentally" from that of margins on stock investments and that "the financial performance control aspect of futures margins has operated in a sound and effective manner on an intra-market basis." All knowledgeable observers, including even Secretary Brady while he was in charge of the inquiry leading to the Brady Report, agree that the futures markets are in the best position to make the delicate adjustments necessary to make margins effective, and that their self-interest in the financial security of their markets is sufficient incentive to assure that they do the job correctly.

Thus, the differences between the role, function and level of futures and stock margins exist as a natural and necessary result of the very different functions these two markets perform. They are not the result of a regulatory gap or loophole. Perhaps the clearest evidence of this comes from securities options markets whose purpose and function is, in many respects, similar to that of futures markets and whose margins are regulated by the Federal Reserve Board and the

Securities and Exchange Commission. Securities options margins have been, if anything, lower than comparable futures markets margins.

The persistent suggestion that futures margin levels were instrumental in driving stock prices above fundamental values is illogical. The cost of speculating that the market will decline is equal to the cost of speculating that it will rise. There is no bias in either direction. Indeed, in futures, there is a short for every long. Moreover, the total open futures positions represented less than 1% of the value of the shares listed on the New York Stock Exchange as of October 15, 1987. If every dollar of S&P futures positions represented unwarranted speculative demand, the total impact on the demand in the securities market would still be utterly insignificant.

CONCLUSION

Changing the regulatory structure will not forestall market breaks. Indeed, without attempting to predict the market direction one way or another, there are abundant reasons why the market could decline, even precipitously. One need only pick up the daily newspaper to find that many commentators believe that, current market record highs notwithstanding, the stock market has ignored fundamental economics and may be in for a rough time. Should a market break occur, it will very likely begin in futures markets because these markets often act as the first line of defense for investors, that is their structural purpose, however this fact will not make any such market break the fault of futures markets (or for that matter the fault of any market), nor will the cause be that there are separate regulators between futures and securities.

An unbiased and highly knowledgeable observer, SEC Commissioner Edward H. Fleischman, has put it best. He believes that the competition between the SEC and CFTC has led to more innovation rather than less. He questions whether the SEC could actually regulate the futures markets without strangling them. And, he ventures that if the SEC had the jurisdiction it would do nothing to protect capital markets that the CFTC has not already done.

TESTIMONY

My name is Leo Melamed. I am Chairman of the Executive Committee and Special Counsel to the Board of Governors of the Chicago Mercantile Exchange (CME). Also representing our Exchange today are John T. Geldermann, CME Chairman, and William J. Brodsky, our President.

We last appeared before you on May 18, 1989. At that time, we carefully detailed our response to the lessons taught by the October 19, 1987, world stock market collapse and the after-effects of that phenomenon. We described each step the CME had taken in response to the recommendations of the White House Working Group and the Brady Commission. We do not intend to recapitulate that testimony nor list the many improvements that were implemented. Let there be no mistake, however, that when action was necessary we acted promptly and in the best interests of the customers of all exchanges.

Despite our prompt and thorough response to every substantive issue and despite numerous independent academic studies supporting our views, we are today faced by a piece of legislation founded on five ***false*** assumptions: (1) that the legitimate issues have not been addressed by the exchanges; (2) that the market crash was a consequence of the regulatory structure; (3) that future stock market crashes can be avoided by a jurisdictional rearrangement; (4) that inter-market trading violations are rampant and cannot be prosecuted under the present regulatory regime; and (5) that somehow investor confidence in the markets has been damaged by virtue of separate regulators.

We fully understand that this Committee's paramount concern is with the impact of our margin system on the financial strength of our Exchange, financial markets and the banking system. We propose to deal with that issue in depth. But, it is necessary to go beyond that one issue. The Bill put forward by the Administration is based upon claims that there is an urgent need for legislation, a claim that is insupportable. But even if there were a need to act -- which is doubtful -- this Bill is not the answer.

The Administration's Bill would do severe injustice to the regulatory structure for futures markets -- America's greatest financial success story and a U.S. resource that is the envy of every other industrial nation. It offers an unrefined approach to the very sensitive and delicate problems of market regulation, one that was formed to satisfy the special interests of a host of diverse constituencies. Rather than causing "minimum disruption to markets" as the Treasury asserts, this Bill is likely to cause untold regulatory and trading problems. For example, the legislation would:

A. Eliminate, without justification or explanation, all federal regulation of off-exchange trading in financial futures and options;

B. Force self-regulators -- the futures exchanges and the NFA -- to administer overlapping and inevitably inconsistent regulatory requirements, and subject these organizations to the control of two different and sometimes uncooperative regulators;

C. Force registrants, such as introducing brokers, futures commission merchants, commodity advisors and pool operators, to comply with duplicative, potentially contradictory regulatory schemes administered by two different regulators;

D. Create a confused, expensive, and problematic scheme of civil anti-fraud remedies that is far more expansive than any now in existence; and

E. Create uncertainty in the clearing process by subjecting futures clearing houses to regulation by two federal agencies, which will inevitably lead to the imposition of inconsistent requirements and intolerable delay during periods of stress.

TRANSFER OF JURISDICTION

There has been a call from some quarters to eliminate the Commodity Futures Trading Commission (CFTC) as the regulator of futures markets that trade equity-based indices. Two reasons have historically been advanced to support this demand.

1. ***It is claimed that the recent extreme market gyrations would not have occurred, or would have been less extreme, if there had been a single regulator.***

The claim that a single regulator would have mitigated the market's movement is not supported by the facts. The record is absolutely clear that the CFTC, the Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE) and the CME were in constant and complete communication during the events. We also had the benefit of a long-standing cooperation agreement. The markets and the agencies worked together without friction and for a single purpose. Absolutely none of the studies that dissected the 1987 crash and the market moves of October, 1989 found any regulatory gaps that triggered or exacerbated either situation.

The greater understanding of market subtlety and workings that existed by reason of the specialized knowledge of the separate agencies was a plus in managing the situation rather than a detriment that needs to be cured. No one regulator suggested an action that was rejected by another regulator or by any of the exchanges.

Unable to show how futures contracts *per se* or the current regulatory split caused or exacerbated the recent extreme moves, the critics have begun to argue that the markets are fundamentally less stable since the creation of stock index futures under the CFTC. The Treasury Department has claimed that since 1982 and the introduction of stock index futures, there have been four market declines greater than 6% that were not related to fundamentals, while between 1940 and 1982, there were only three such declines and they were all caused by news events. Added to this claim has been the assertion that no one can even remember the underlying causes of the 1987 stock crash or the most recent one in October of 1989.

For the record, on February 2, 1988, Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, testified before the Committee on Banking, Housing and Urban Affairs of the United States Senate. He agreed with our macro-economic analysis and offered this rationale for the underlying cause of the 1987 crash:

> [S]tock prices finally reached levels which stretched to incredulity expectations of rising real earnings and falling discount factors. Something had to snap. If it didn't happen in October, it would have happened soon thereafter. The immediate cause of the break was incidental. The market plunge was an accident waiting to happen.

Moreover, as all independent academic studies concluded, the 1987 stock market crash did not begin in the United States nor was a regulatory gap its cause. It was a global event that started in Japan and worked its way around the globe, following the opening of each major national market. Indeed, according even to the Brady Report itself, the 1987 break in equity values in the U.S. and other countries was a consequence of economic fundamentals and began several days before "Black Monday:"

> On Wednesday morning, October 14, 1987, the U.S. equity market began the most severe one-week decline in its history....**Thursday, October 15** Selling in Tokyo and London overnight continued the pattern seen in New York and Chicago on Wednesday....**Friday, October 16**...The Dow was off 108 points, the largest one day drop ever, on volume of 338 million shares....**Monday, October 19** In Tokyo, the Nikkei Index, Japan's equivalent of the Dow, fell 2.5 percent. Investors in London sold shares heavily, and by midday the market index there was down 10 percent....Selling activity shifted to the U.S. when the equity markets opened.

With respect to the market break on October 13, 1989, the events were more sudden. Most informed observers agree that the underlying cause was news of the collapse of the leveraged buy-out of UAL. The news was of an extreme shocking nature to the market. It not only had an immediate impact on stock values, but the market sensed that the end of an era of stock prices inflated by buy-out pressure may have occurred. In many ways, this news was more "fundamental" than any economic impact that might have come from (say) a president's heart attack which is cited by the Treasury as an acceptable fundamental reason for a market break.

The Treasury Department's view also suffers by taking a selective view of history. There have always been periods of calm and turbulence in our financial markets. Professor

Robert Mackay of Virginia Polytechnic Institute has compiled an extensive summary of major market moves in the past century. He further reviews all the major academic research on stock market volatility. The overwhelming evidence shows no link between the trading of futures and extreme volatility.

2. *A second ground for the elimination of the CFTC as a regulator of futures contracts based on securities-type products is the assertion that these futures contracts are functionally equivalent to the securities that underlie them.*

This argument is groundless. It is exactly like arguing that energy futures ought to be regulated by the Department of Energy because both relate to energy, or ocean shipping insurance ought to be regulated by the Maritime Commission because both relate to boats. The fact is that futures trading is a species of insurance. The method by which the product is traded, marketed and regulated is completely different than comparable securities transactions.

Futures markets are composed of an array of different underlying instruments, none of which are assets comparable to the equities regulated by the SEC. There are agricultural products, currency products, interest rate products, metals products, energy products, as well as the equity index products. It is not rational to argue that each of these product lines should be governed by a different regulator -- one whose primary responsibility is to regulate the underlying product. The result of such disjointed regulation is confusion, inefficiency, and contradictory regulations -- all to the complete disservice of the marketplace.

The only sensible allocation of regulatory responsibility is the one presently adopted by the Congress. Since all futures markets have a common denominator -- all are traded in the same fashion under the same set of rules and apply a similar system of financial safeguards -- they should all be regulated by a single regulator and a unified set of regulations.

Of late, the Treasury has added four additional provocations to justify a jurisdictional transfer: (1) evasion of short-selling restrictions; (2) ineffective inter-market enforcement; (3) barriers to innovation; and (4) clearance and settlement breakdowns.

Manipulation by Concerted Short Selling is not a Futures Market Problem.

The Treasury argues that the separate existence of futures markets allows evasion of the "short selling restrictions." It asserts that a concerted selling effort in the futures market undermines the restriction and that "low" futures margins can accelerate the stock market down draft. Treasury fails to recognize that concerted selling in futures markets is illegal and that futures markets impose significant restrictions on the size of positions that any speculator may assume. Treasury fails to recognize that the futures markets can easily detect and prevent such conduct.

But, the most glaring defect of the argument is that the securities option markets regulated by the SEC do not have any short selling restriction either, nor could they (nor could any futures market) and continue to function effectively. Moreover, in many cases the margins imposed on persons assuming short position equivalents in the SEC-regulated options markets are less than futures margins for positions of equal size.

The CFTC and Futures Markets Effectively Deal with Inter-Market Violations.

The claim that the split in regulation has precluded effective prevention of manipulation and fraud in transactions between stock and futures markets has a certain justice to it, but the imperfection has been the consequence of the SEC's failure to require its regulated exchanges to implement audit trail systems and compliance programs on a par with futures exchanges. Futures exchanges maintain accurate large trader reporting systems that permit next-day identification of the members and customers that hold large positions and that have traded.

The CME has such information on 85% to 90% of the positions in its S&P 500 contract. The contrast with securities markets is startling:

> Due to the absence of any large trader reporting vehicle to reconstruct stock market activity, the [SEC's] Division [of Market Regulation] attempted to use the existing electronic bluesheeting system to identify those entities that were active in equities on October 13 and 16. As originally designed, the Division sent trade request to approximately 50 broker-dealers, asking for trade information in 132 selected stocks. ... The volume in those stocks represented approximately 50% of the total NYSE volume for those days. ... The firms noted that absent substantial time and programming costs, they would be unable to aggregate trade information. Further, the firms noted that they were unable to attach trade times to the data submissions, thereby making it impossible for them to respond to the specific inquiries for the afternoon of October 13 and the morning of October 16. As a result, the Division was forced to accept unsorted dumps of all activity in the 132 stocks by the broker-dealers...[1]

In its market surveillance of index products, the NYSE relies primarily on its daily program trading reports. These reports are generated from input that is separate from the regular NYSE audit trail. It should be noted that the regular audit trail program uses execution times while the daily program trading report uses program entry times. Therefore, there may be variances in the timing of trades associated with program trading as the entry times (program trading reports) are often very different from the execution times recorded in the regular audit trail.

In contrast, the audit trail for execution times is much more accurate in the futures industry. The CME, using its Computerized Trade Reconstruction (CTR) program, is able to determine the time of execution without similar confusing ambiguities with a high degree of precision and confidence.

The CME, in particular, has been at the forefront in voluntarily sharing market information in order to coordinate inter-market surveillance. For instance, the CME listed its first stock index product on April 21, 1982. In March, 1983, the CME and CBOE began informally exchanging market information. By June 21, 1983, the CME and CBOE had entered into an information-sharing agreement on an as-needed basis. Thereafter, both exchanges engaged in pre-expiration reviews. All of the above was done on a voluntary basis.

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[1] U.S. Securities and Exchange Commission, A Report by the Division of Market Regulation, *Trading Analysis of October 13 and 16, 1989*, May, 1990.

In marked contrast, it was not until eleven years after the listing of options on stocks that the Intermarket Surveillance Group (ISG) was formalized at the mandate of the SEC. Almost from the inception of stock index futures trading, the CME actively participated in ISG discussions respecting its stock index products and has provided information, upon the request of ISG members. As a logical outgrowth of this, all the futures exchanges that trade a stock index product (CME, CBOT, NYSE and KCBT) have become affiliate members of the ISG. As affiliate members, the futures exchanges can request, on an equal footing, market information respecting products related to their stock index contracts.

The actions taken by the CFTC and SEC in response to a joint submission of an intermarket front-running proposal by the CME and NYSE are instructive as to the way in which such proposals might fare under a wholly SEC regulatory scheme. While the CFTC approved the CME's rule interpretation within ten business days, the SEC took nine months to approve the NYSE's identical submission. If there has been a delay in the regulatory approval of this proposal, it can be laid totally at the feet of the SEC.

Innovation Under CFTC Jurisdiction has Fueled America's Financial Markets.

The argument that the CFTC has been a barrier to innovation is particularly rankling. The SEC vigorously opposed approval of stock index futures by the CFTC. Today, stock index futures are actively traded in Tokyo, Osaka, London, Paris, Singapore, and elsewhere, all following the American model.

Financial futures that were invented in Chicago eighteen years ago have transformed risk management. The futures exchanges, with CFTC oversight, created contracts in currencies, interest rates, and stock indexes. This financial futures revolution blazed the trail for much of what has since followed in world capital markets. It established that there was a need for a new genre of risk management tools responsive to institutional money management and modern telecommunication technology; it led to the acceptance and integration of futures and options within the infrastructure of the financial establishment; it acted as the crucible of ideas for new off-exchange products; it became the catalyst for the development of futures markets worldwide; and it induced the introduction of risk management as a regime.

As a consequence of their worldwide acceptance, these markets are today utilized by investment bankers and broker-dealers, by foreign exchange traders and government securities dealers, by banks and insurance companies, by pension funds and mutual funds, and by corporations and financial institutions of every sort. The contribution of equity derivative markets to overall U.S. market liquidity as well as to the U.S. capital formation process cannot be underestimated and is documented by every academic study. They represent an American resource we dare not endanger lest we endanger our entire market structure. Indeed, Merton Miller, Professor of Finance at the University of Chicago, named financial futures as "the most significant financial innovation of the last twenty years."

Similar products were approved by the SEC for securities exchanges but only after the proved success of their futures market counterparts. The securities industry and the SEC, for the most part, simply copied the innovations created in the futures industry.

In fact, the most important development in securities exchanges during the last twenty years has been the creation of options on individual securities most traded on the CBOE, AMEX, PHLX, PSE and NYSE. The innovation is a direct result of a perseverance in the face of intractable SEC opposition of the Chicago Board of Trade.

The current controversy over stock index futures jurisdiction is not novel. Since their creation by Chicago's futures markets, the SEC has attempted to assert jurisdiction over these products. Both Congress and the courts have reviewed the dispute on numerous occasions and come to the same conclusion each time: stock index futures contracts are properly regulated by the CFTC, the agency specifically created to oversee the complex and highly-regulated trading of risk-shifting futures contracts. The reasons are simple. First, futures products are valuable financial instruments.

> Benefits of active futures markets are real: for example, they apply directly to the Treasury securities market. ... to lower interest costs for the Federal Government... [2]
>
> What many critics of equity derivatives fail to recognize is that markets for these instruments have become so large not because of slick sales campaigns but because they are providing economic value to their users. By enabling pension funds and other institutional users to hedge and adjust positions quickly and inexpensively, these instruments have come to play an important role in portfolio management.[3]

Recent charges by the SEC suggest that despite the futures industry's track record for innovation, futures exchanges are now using the law to stifle innovation. For support, they cite to the recent Seventh Circuit decision concerning Index Participation (IP) contracts. However, the facts underlying that case refute this assertion.

IPs are stock index futures contracts with minor variations in conditions of delivery. These contracts were submitted by the Philadelphia Stock Exchange (PHLX) and the American

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[2] George D. Gould, U.S. Treasury Under Secretary for Finance, *Testimony before the House Subcommittee on Telecommunications and Finance*, May 19, 1988.

[3] Alan Greenspan, Chairman, Federal Reserve Board of Governors, *Testimony before the House Subcommittee on Telecommunications and Finance*, May 19, 1988.

Stock Exchange (AMEX) to the SEC and approved by the SEC despite the fact that in 1982 Congress expressly gave the CFTC exclusive jurisdiction over stock index futures contracts and the SEC exclusive jurisdiction over options on stock indices. Critically, both of those exchanges had and continue to have futures exchange affiliates through which they could have properly traded these contracts after CFTC approval. They deliberately chose not to do so.

The CME and CBOT filed suit in the United States Court of Appeals for the Seventh Circuit to have the SEC's approval reversed. The Seventh Circuit agreed and reversed. The United States Solicitor General has determined that the Seventh Circuit's decision is correct and refused to permit the SEC to appeal the decision to the Supreme Court. The Supreme Court denied *certiorari*.

Significantly, the CFTC had been, and appears still to be, prepared to approve trading of these contracts and even offered to expedite cross registration of SEC account executives who may wish to offer the contracts to the public. The securities exchanges have consistently refused to accept the CFTC's invitation.

> As you are all aware, index participation contracts are no longer trading after the Court of Appeals agreed with the futures exchanges that IPs were futures contracts. What you may not be aware of is the effort the CFTC made to see these products trade. Staff from the CFTC and SEC met on numerous occasions to try to resolve the regulatory and jurisdictional issues. During these meetings, the CFTC offered to address concerns about the loss of the securities retail network if IPs were designated as futures contracts by taking up a proposal for cross registration of account executives (AEs) and associated persons (APs). In response to concerns about futures style trading systems, the CFTC offered to take up proposed rules for a specialist or board broker style trading system along with rules for large order execution of IPs. These overtures were rejected.
>
> After the Seventh Circuit Court stopped the trading of IPs on securities exchanges, the CFTC contacted counsel for the PHLX and the AMEX and offered to designate the IPs contracts -- on an expedited basis -- on their futures subsidiaries. Once again, the CFTC offered to take up cross-registration of AEs and APs along with proposed rules for different trading systems. The securities exchanges chose to pursue their case in court and, as a result, index

participations are not now trading. The CFTC, however, did support the NYSE basket product -- that's innovation.[4]

Supporters of the amendment argue that America's time and energies are being spent on wasteful litigation, while our foreign competition places its efforts into product development. The removal of the exclusivity clause will supposedly pave the way for this country to stand toe-to-toe with all foreign competitors that do not face this jurisdictional split. In fact, the above statements show that the IP litigation could have easily been avoided, but a confrontational route was purposely charted by the exchanges offering IPs.

Under these circumstances, it cannot reasonably be said that the exclusive jurisdiction of the CFTC is preventing the offering of "innovative" new products. In the first place, the products are not new or innovative; they are modified versions of the contracts created by Chicago futures exchanges years ago. Second, the only thing preventing them from being brought to market is the refusal of the offering securities exchanges to have the CFTC approve and regulate them as Congress has long required.

The SEC maintains that this decision sends IP products to foreign markets, and they regularly cite the Index Participation contract trading in Toronto as proof. It should be noted that the Toronto contract is an interest in a pool of Canadian securities, much like an open-end mutual fund. It is genuinely a security and if any of the American IP products had been structured in the same manner, there would have been no dispute. Evidence that this is the case comes from the recently-introduced NYSE stock baskets. These securities, appropriately regulated by the SEC, were introduced without complaint by the CFTC or the exchanges trading stock index futures. The SEC's smoke screen on this issue is pierced by the fact that no successful AMEX or PHLX-style IPs, based on any country's securities, are currently being traded anywhere in the world today to the best of our knowledge.

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[4] Wendy L. Gramm, Chairman, Commodity Futures Trading Commission, *Setting the Record Straight*, February 15, 1990.

Further, the SEC insists that the Seventh Circuit decision means that if a financial product has one percent (1%) of futurity, the CFTC has exclusive jurisdiction. This is simply untrue; the IP decision says no such thing. The case merely held that the IP product had mostly elements of a futures contract and no elements of an option on an index (the product over which the SEC has exclusive jurisdiction). Many futures-like products are freely trading today in totally unregulated markets; interest rate and currency swaps are but two of many such examples. The CFTC has not asserted jurisdiction over these products. Moreover, the SEC has exclusive jurisdiction over options on stock indices and, at SEC insistence, no one may trade futures contracts on individual equity securities. Therefore, the SEC's contention that the CFTC's exclusive jurisdiction stifles innovation while that of the SEC does not is simply contrary to fact.

Futures Market Clearing and Settlement Systems are Superior.

The assertion that clearance and settlement systems will benefit from the transfer of jurisdiction to the SEC has no basis in fact. We must not lose sight of the stark distinction between futures exchange clearing systems and securities exchange systems. Futures exchanges settle on a next-day basis rather than the five-business-day basis common in securities systems. Futures markets mark positions to market each day and frequently more than once each day. Futures exchanges operate a no-debt system. There has never been a financial failure related to stock index futures trading.

Subsequent to the crash of 1987, the Chicago Mercantile Exchange corrected all of the perceived weaknesses in its systems. It enhanced its clearing-bank agreements and improved the fund flows. It regularly meets with the other markets and the Federal Reserve in order to promptly implement any other improvements that may be conceived.

The strength of the system for futures can be easily demonstrated. During the 1987 crash, no clearing firm at the CME failed, while there were three such failures at the National Securities Clearing Corporation (NSCC) and one at the Options Clearing Corporation (OCC). After this experience, the CME made many further improvements, and did not rest on its track record.

When the major move of October 1989 took place, the system was ready and funds moved without a hitch. Once again, however, on the SEC side there was trouble. A clearing firm at the OCC did not meet a margin call on October 13, and the firm had to be absorbed completely by another member to avoid a default. There is nothing in this experience, or in an analysis of the systems, to suggest that SEC oversight would aid the financial stability of the nation's markets.

CFTC Experience and Skill are Outstanding.

We have spoken at length with legislators who are firmly convinced that the CFTC is not as experienced, nor as firm, nor as knowledgeable as the SEC. These legislators are simply reluctant to trust the CFTC with the sensitive job of regulating financial futures contracts. We have suggested the same response to all who have criticized the CFTC. We urge them to stop talking generalities, step back from rumors, ignore unsupported editorials and look at the facts. The facts and the record are clear. In every identifiable area of regulation, the CFTC compares favorably with the SEC.

This Committee does not have the time to do a full comparison, but we recommend a review of the CFTC's record in the areas of: (1) protection of customer funds; (2) prevention of frauds on the market; (3) prevention of frauds on customers; (4) prevention of manipulation;

(5) prevention of insider trading abuses; and (6) punishment of those who violate the rules of commodity markets.

Investor Confidence.

Finally, the argument has been advanced that somehow investor confidence in the market has been damaged by virtue of separate regulators between futures and securities and/or by virtue of market volatility which allegedly results from some of the inter-market related techniques such as program trading and index arbitrage. This argument is a blatant misdirect.

The New York Stock Exchange Panel on Market Volatility and Investor Confidence, which recently submitted its findings to the NYSE and testified before Congress, performed an extensive survey of public customers to identify what concerned them most in today's market. Two thirds of the respondents said they have "no concerns" about the current stock market. That finding is striking enough when we are continually being told by "experts" that the opposite is true. What is even more striking are the responses when the survey dug beneath the layer of general sentiment and probed specific areas.

When asked about how concerned they were about specific market features, the respondents cited stock broker honesty and ethics as the area of their greatest concern. Interest rates, inflation, recession, insider trading, and bankruptcies of business were of much greater concern than volatility or program trading. The only conclusion that can be drawn is that those who would try to frighten the Congress into an ill-advised action based on claims of investor dissatisfaction, do so without finding out where the public's concerns really are.

Nor is it a valid argument that the small investor has left the marketplace as a consequence of the foregoing concerns. It is true that volume of transactions at both the New York Stock Exchange and at the Chicago Mercantile Exchange stock index market is down from pre-1987 days. There are a multitude of reasons that can be attributed to this fact, but they have little to do with small investor concerns about market regulators or volatility.

The small investor has left the market only as an individual stock picker. He has shifted his resources into professional management. According to data from the Investment Company Institute, assets in all mutual funds grew from 770 billion dollars at the end of 1987 to over one trillion dollars today. Over this period equity funds have grown over 48% while bond and income funds have increased just 12.3%. Additionally, U.S. pension funds now total 60 million plan participants plus beneficiaries and hold $2 trillion for them, compared to only $400 billion a decade ago. The American small investor is thus still a major force in the market and enjoys major benefits from professional fund management. This trend by the public toward professional management in finance has been evident for over two decades. It is a gross disservice to the Congress to suggest that such long standing small investor attitudes and investment trends are somehow connected to current issues relating to a single or multiple regulator for futures and securities markets.

DEFECTS OF ADMINISTRATION BILL

Disregard of Basic Standards of Public Protection.

The Administration's Bill seems crafted to serve the special interests of certain stock exchanges, oil brokers, government securities dealers, swap dealers, etc To achieve these ends, the Bill exempted from regulation all futures-like transactions in financial instruments that are not voluntarily submitted to the CFTC for regulation. The CFTC's jurisdiction over financial instruments is restricted solely to those transactions that are traded on an exchange designated by the CFTC. But, since the CFTC designates on a contract-by-contract basis, even a current exchange could avoid subsequent CFTC regulation by simply refusing to submit its new contracts for designation. Moreover, its existing contracts may be withdrawn from CFTC regulations by the simple expedient of delisting.

Congress should not forget that the Commodity Exchange Act was intended in large measure to protect the public against the operation of bucket shops that had, prior to the Act, systematically defrauded the public and endangered the credibility of legitimate futures markets. The Administration Bill is a license to reopen bucket shops.

Creation of Duplicate and Inconsistent Regulation.

The Administration's Bill bifurcates government regulation of futures exchanges and of the futures industry's self-regulatory organization, the National Futures Association (NFA). While the Bill purports to limit SEC oversight to the activities of these entities that are related to stock index products, the hard fact is that the work cannot be neatly subdivided.

Exchange and NFA rules, ranging from governance to trade practices, are not contract specific. The rules apply across the full spectrum of exchange activities. CFTC and SEC standards respecting exchange governance and trading practices differ markedly. The immediate impact of the Administration's Bill will be to require the exchanges and the NFA to submit all rules of general application to both the CFTC and the SEC. The mere fact of multiple review is certain to increase costs and cause delays. More importantly, it is certain to result in inconsistent agency rulings and force the exchanges and the NFA to bifu[illegible] their operations. It will not be possible to maintain a single rule book and a single system of governance.

Membership rights and responsibilities will also need to be bifurcated since different membership standards will apply depending on the product being traded and the trading rules may need to differ on a pit-by-pit basis. The most important responsibility of an exchange, to take prompt and effective action in the face of a market emergency, will be disrupted by this split in jurisdiction. If the emergency action applies to all contracts, as is the case where there is a communication disruption or other physical or general financial emergency, the differing standards of the SEC and CFTC will preclude prompt and effective responses.

Registered Persons.

The Administration's Bill subjects person, now registered with the CFTC, to registration and regulation by both CFTC and the SEC. Registrants such as introducing brokers, futures commissions merchants, commodity trading advisors and pool operators, will be subject to two potentially conflicting regulatory schemes with no clear mechanism for allocating responsibilities, resolving conflicts, or eliminating duplication.

The Bill attempts to ameliorate this effect by grandfathering all existing registrants and only requiring new registrants who wish to trade the full range of futures products to register with both the SEC and CFTC. While this will afford existing registrants some savings, the costs to new registrants will be doubled. Moreover, existing registrants need to re-register on a regular, frequent schedule.

A serious question will arise respecting the jurisdiction of state regulators, who have traditionally governed securities professionals. Futures professionals have been exempted from duplicate state regulation. The Bill almost guarantees an extensive, expensive, and debilitating jurisdictional fight which will weaken the industry.

Increased Risk to the Clearing House.

The Administration's Bill shifts to the SEC regulatory control over the futures exchange clearing houses' activity in stock index futures. It leaves the CFTC with regulatory control of all of the clearing houses' other activities. This is an entirely unworkable regulatory scheme which will endanger the safety and stability of the financial structure of futures market clearing houses.

Clearing House rules are not contract specific and are applicable to all contracts and all members. The standards for membership, capital requirements, time periods for submitting data and posting margin, acceptable forms of margin, required banking relationships, operational capability, etc. apply across the board. The Administration's Bill will require that each of these rules be submitted to both the SEC and the CFTC for approval. It will preclude the clearing house from implementing the new rule until approval from both agencies is received. Moreover, if either agency exercises its authority and causes a submitted rule to be amended, then the clearing house will be precluded from acting until it is able to get absolute agreement from both agencies on the wording of any amendment. This creates an entirely intolerable situation. There is no mechanism whereby differences between the SEC and the CFTC must be promptly resolved. There is no way in which an exchange can do business under these circumstances.

Implications for Government.

The transfer to the SEC of regulatory responsibility for stock index futures will add significantly to the federal cost of regulating the financial markets with no demonstrable public benefit. Commissioner Fleischman correctly stated that the SEC does not really understand futures markets and is not likely to be an adequate regulator. The SEC currently is without staff and expertise to perform these responsibilities. It indicated that the transfer of stock index futures jurisdiction may require the SEC to add 100 additional staff. That is a large portion of the CFTC's total staff. It is not true, however, that the CFTC will be able to reduce its staff by an equivalent number if the transfer is made. The cost to the SEC will be large, the savings to the CFTC marginal.

MARGIN POLICY

Margin levels at futures exchanges are variously blamed for increasing prices, falling prices, and/or higher volatility levels. It is true that the purchaser of a futures index contract must, in the initial instance, deposit between 10% and 20% of the underlying value of the contract while a retail stock buyer may only borrow 50% of the value of his stock. But, the comparison is misleading.

As we have stated many times, futures "margins" are performance bonds posted by both parties to the transaction, while stock margin is exactly akin to a down payment made by the purchaser of a house or car. Stock margin defines how much of the value of the asset may be borrowed, while there is no borrowing or lending in futures contracts. The two activities share only the name, but that does not prevent commentators from making more extensive comparisons based on risk coverage or leverage provided. From neither perspective is there any justification for a change in the way futures margins are set or monitored.

Individual stocks are considerably more volatile than the diversified portfolios on which stock index futures are based. Many studies, including one done by the Federal Reserve Board after the 1987 crash, show that differences in basic volatility and the settlement and payments cycle require margins on individual stocks to be several times higher than those on index futures to cover the same risk.

Further, stocks settle in five business days while futures settle the next day. Also in contrast to securities markets, futures markets maintain a virtual "no-debt" financial system. All futures market positions are marked-to-market on a daily basis, *i.e.*, any value changes in futures positions representing losses must be paid for in cash at least on a daily basis. This critical difference acts as a foundation for many other fundamental differences between the securities markets and the futures markets.

Pursuant to normal procedures, the CME calls for payments two and sometimes three times during a single trading session. Losses on futures positions do not accumulate. This financial system, substantially safer than other systems that allow losses to accumulate for many days, avoids the need for high initial margins to maintain financial integrity.

Many critics seemingly don't care about covering risk, but instead talk about "dangerously low margins" producing huge leverage for speculative runs on the market. These critics usually cite the hedge margin, currently around four percent of the value of the S&P 500 stock index futures contract, as the value producing these great ills. This argument cannot bear examination.

Hedgers in the S&P 500 stock index futures contract routinely trade by posting the hedge margin and having their positions marked-to-the-market daily. On the SEC side, hedging is done with options, and for these situations there are a myriad of rules where the basic margin may be only one or two percent of the value of the underlying instruments. For many hedge strategies there is no margin whatsoever.

These comments are not made to suggest these rules, approved by the SEC, are wrong or produce undesirable leverage. Quite the contrary. These (SEC regulated) hedge positions are recognized as being low-risk, no-leverage strategies which do not require high additional deposits. A mutual fund that hedges its portfolio by taking a short position in stock index futures is no different. For some reason, however, the SEC and Treasury argue that managing risk with futures does not deserve the same common-sense business treatment long afforded to users of SEC products.

When one compares professional traders in each market, one must conclude that futures margins are not only prudent from a financial standpoint, but are also quite comparable to those prevailing in the existing SEC-regulated environment.

Some ask why the margins can not be set at very high levels "just to be on the safe side." The answer to that is that margin amounts require dedicated capital that is not free. Higher margins make hedging more expensive, and there is no reason to create unnecessary expenses beyond that created by prudent margins. The cost of engaging in futures transactions mirrors the risks entailed by those transactions. This leads to efficient pricing and allows our market to serve the very purpose commanded by this Congress. We provide low-cost and efficient insurance for agricultural and financial institutions that wish to shift their risks to speculators who are willing to absorb those risks.

The Brady Report unequivocally concluded that as regards "the intra-market financial performance control aspect of margin," futures margins differ "fundamentally" from that of margins on stock investments and that "the financial performance control aspect of futures margins has operated in a sound and effective manner on an intra-market basis."

We agree with this assessment, and we believe that the financial performance of the futures industry during the 1987 crash illustrated the value of maintaining the authority for financial and margin decisions in the same place as the expertise resides -- at the exchanges. We also recognize, however, that the crash demonstrated the unpredictability of the financial environment, and emphasized the need for constant re-evaluation of risk management procedures.

All knowledgeable observers, including Secretary Brady while he was in charge of the inquiry leading to the Brady Report, agree that the futures markets are in the best position to make the delicate adjustments necessary to make margins effective, and that their self-interest in the financial security of their markets is sufficient incentive to assure that they do the job correctly.

On March 31, 1988, Chairman Greenspan testified before the Committee on Banking, Housing and Urban Affairs of the United States Senate. He had the full benefit of all of the reports and studies of the October 1987 crash. His view as to the cause, severity and rapidity of the crash were confirmed: it was a result of a "confrontation between dramatically changing computer and telecommunications technology and unchanging human nature."

Chairman Greenspan's analysis of the aftermath of the crash and the need for corrective legislation also benefitted from the availability of the studies and reports. He concluded that the concern with the impact of portfolio insurance as an exacerbating factor has abated. The market clearly taught a lesson to those who failed to realize that the high degree of liquidity necessary to execute the strategy would not exist during the extreme market conditions that would pertain at the exact time that the strategy became operative. The strategy has been modified or markedly scaled back.

Chairman Greenspan concluded that the current level of margins in futures markets provides "clearinghouses and other lenders with roughly comparable protection against credit losses..." He recognized the superior knowledge of the exchanges and their overwhelming self-interest in correctly setting margin levels and concluded, "we should rely where possible on the private organizations to correct the problems that were evident last October."

Critics have also alleged that low futures margins encouraged speculative demand for stock index products, which in turn led to an overpricing of U.S. equities. The charge that efficient speculation is linked to market instability has been debated at length by our nation's finest economists. See, *A Review and Evaluation of Federal Margin Regulations, A Study,* by the staff of the Board of Governors of the Federal Reserve Bank, December, 1984, or for a comprehensive bibliography see S. Figlewski, *Margins and Market Integrity: Margin Setting for Stock Index Futures and Options*, Working Paper Series #csfm-83, 1984. Direct tests of the effect of margin requirements on price volatility in the stock market have found little apparent relationship.

Unfortunately, the casual reader of the Brady Report, including some of our prominent editorial writers, concluded that the Commission actually found that the market was overvalued by reason of "excess speculation" made possible by "low" futures margins. Those same editors also concluded that the market drop was intensified by the involuntary selling of overextended futures market "speculators" pressed by margin calls. These are not the findings of the Brady Report. Indeed, there is nothing in the Brady Report to support either of those conclusions and the facts are directly contrary to them.

The persistent suggestion that futures margin levels were instrumental in driving stock prices above fundamental values is illogical. The cost of speculating that the market will decline is equal to the cost of speculating that it will rise. There is no bias in either direction. Indeed, in futures, there is a short for every long. Moreover, the total open futures positions represented less than 1% of the value of the shares listed on the New York Stock Exchange as of October 15, 1987. If every dollar of S&P futures positions represented unwarranted speculative demand, the total impact on the demand in the securities market would still be utterly insignificant.

Indeed, if the futures markets were a home for "excessive" speculative demand, one would expect to have seen the open interest in futures contracts growing at a rapid pace during 1987 when the equity market made its sharpest upturn. That was simply not the case. Furthermore, since the United States had the only well developed futures markets for stock indices, one would expect that any impact of "low futures margins" could be seen by comparing performance of U.S. securities markets to foreign securities markets unaffected by "low futures margins." No such impact can be found. U.S. stock prices rose less than comparable markets that existed without stock index futures contracts, and the U.S. price-earnings ratio increase was middling in comparison with the other 18 largest industrialized countries.

Moreover, in this instance, the actions of foreign stock exchanges contradict this simplistic claim. Generally, foreign markets experienced greater appreciation than the U.S. market both in price levels and price/earnings ratios during the 1980s. Those foreign markets were not fueled by stock index products. The presence of an efficiently margined, strong stock index futures market in the U.S. did nothing to push U.S. stock values out of line with the rest of the world.

Some critics have charged that over-extended investors were forced out of the futures market by margin calls and that a downward spiral followed. The Brady Commission hypothesized that large futures speculators were forced to liquidate during the crash and thus caused a downward price spiral. That theory was contrary to fact. Speculative accounts were significant buyers on October 19. Rather than exacerbating the decline, speculators helped to cushion the market against the selling of pension funds and other institutional users of the S&P futures contract. Furthermore, whereas a forced liquidation would result in panic selling by speculators and a reduction in the total number of open positions, the clear fact is that they bought and, as a result, the open interest on our market increased significantly.

Thus, the differences between the role, function and level of futures and stock margins exist as a natural and necessary result of the very different functions these two markets perform. They are not the result of a regulatory gap or loophole. Perhaps the clearest evidence of this comes from securities options markets whose purpose and function is, in many respects, similar to that of futures markets and whose margins are regulated by the Federal Reserve Board and the Securities and Exchange Commission. Securities options margins have been, if anything, lower than comparable futures markets margins.

Despite this fundamental difference, SEC margin control over stock index futures has been advocated to "harmonize" futures and stock margins and eliminate alleged leverage between cash and futures to diminish cash market volatility. First, there is no support for the proposition that the level of futures margins has any impact on volatility in the stock market.

> Although available statistical evidence on the relationship between margins and stock price volatility is mixed, the preponderance of that evidence suggests that neither margins in the cash markets nor in the futures markets have affected volatility in any measurable manner.[5]

Moreover, Congressional investigation fully supports the conclusion that there is no need to "harmonize" (in the sense of "equalizing") futures and cash margins and that, indeed, such an attempt could be extremely harmful.

> If cash and futures margins differ sharply in function and purpose, why should regulation seek to "harmonize" them? The purpose of "harmonization" is to eradicate the "excessive speculation" allegedly induced by the appearance of greater leverage in the futures markets.
>
> "Excessive speculation" is a phantom. Speculative trading on futures exchanges is entirely legitimate, and serves a useful economic function. Speculators provide the capital and liquidity that allows hedgers to transfer risk. The popular fantasy that speculation causes excessive market volatility has not been substantiated by serious research. On *a priori* grounds, speculation can normally be expected to be a stabilizing influence on markets. And, in practice, evidence suggests that it did exercise a stabilizing influence during the market turmoil of 1987. On October 19, "speculative" trades were actually net buyers of stock index futures contracts.
>
> Attempts to suppress "excessive" speculation will render markets less liquid, and therefore more volatile. Imposing substantially higher margins on futures markets would reduce market volume and market liquidity, but there is no reason to assume it would primarily drive out destabilizing speculation. It would just as readily deter stabilizing speculation and hedging. Margin regulation is too

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[5] Alan Greenspan, Chairman, Board of Governors, Federal Reserve System, *Testimony before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, March 29, 1990.

> blunt a tool to employ effectively against destabilizing speculation. (emphasis in original) [6]

It has also been suggested that there should be federal regulatory oversight of margin authority. The fallacy of this suggestion has again been amply demonstrated by Congressional investigation.

> The ability of the futures exchanges to set their own margins appropriately, to ensure financial performance, has been amply demonstrated. During the market crises of October 1987 no participant failed to meet his financial obligations, despite unprecedented price movements and margin calls (intraday and overnight). Various studies and reports on the market collapse, including the Brady Commission Report, found that futures margins operated soundly and effectively to protect the financial integrity of the markets. No federal agency could improve on that record.
>
> The futures exchanges, unlike the Fed, have demonstrated considerable flexibility in changing margins to meet changing market conditions. In 1987 the Chicago Board of Trade changed margin levels over 200 times on all its contracts. In the past two years the Chicago Mercantile Exchange made 10 margin changes alone on its S&P 500 contracts. The Fed, however, has not changed securities margins at all since 1974.
>
> The Fed has eschewed an activist "margin policy" because it has failed to find any useful economic purpose to be served by margin regulation. Any federal agency directed to set futures margins would likely be driven, by the nature of the incentives it faces, to set margins higher than needed to protect financial integrity, thereby imposing excessive costs on futures market traders, contracting market liquidity and impairing market efficiency. The dominant incentive bearing on federal margin-setting authorities would be to escape blame for any untoward market developments. Private exchanges, however, must balance the need to protect their own financial integrity with their desire to promote an active, liquid and efficient market. Setting margins high serves the first objective, setting margins low serves the second. Only the exchanges - not a federal authority - face incentives leading to a proper balancing of these two conflicting objections. (emphasis in original) [7]

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[6] U.S. House Committee on Banking, Finance and Urban Affairs, Report of the Subcommittee on Domestic Monetary Policy, *The Regulation of Futures Margins*, July 28, 1988.

[7] U.S House Committee on Banking, Finance and Urban Affairs, Report of the Subcommittee on Domestic Monetary Policy, *The Regulation of Futures Margins*, July 28, 1988.

The only benefit of an ill-conceived attempt to curb stock market volatility by increasing futures margins will be to impair their valuable segment of the financial marketplace.

> ... [R]aising maintenance margins on stock index futures to levels well above those necessary for prudential purposes could substantially reduce futures market liquidity or drive business offshore.[8]
>
> Imposing substantial costs on traders through higher margins would drive the larger hedgers to seek other outlets for risk transference. Some may turn to less efficient off-market alternatives. Most will eventually turn to foreign futures markets, which, spurred on by the artificial cost advantage we would hand them by setting our margins too high, will quickly develop a complete line of instruments fully competitive with those traded on our domestic futures exchanges. No public purpose could possibly be served by driving the large institutional users of our own well-established and efficient exchanges into foreign hands.[9]

It is also instructive to take note that foreign futures markets, competing directly with our American futures markets for world business, make the same fundamental distinction between securities and futures margin. For instance, the following are samples of futures margins on foreign exchanges as a percentage of contract value on October 16, 1987:

LIFFE:	Long Gilt Eurodollar FTSE 100	2.0% .05% 2.7%
MATIF:	Notional Bond	4.0%
TSE:	Yen Bond	3.0% of nominal value with a minimum of 6 million Yen
HONG KONG:	Heng Seng	7.9%
SIMEX:	Nikkei	5.7%
SFE:	All Ordinaries	3.7%
NZFE:	Barclay's Index	4.8%

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[8] Greenspan, *Testimony*, March 29, 1990.

[9] U.S. House Committee on Banking, Finance and Urban Affairs, Report of the Subcommittee on Domestic Monetary Policy, *The Regulation of Futures Margins*, July 28, 1988.

CONCLUSION

A partial transfer of jurisdiction from the CFTC to the SEC does not come to grips with any of the real issues. The Brady Commission concluded that futures and securities markets were aspects of a single market. We agree, but Secretary Brady did not go far enough. In today's global markets the interrelationship among markets includes futures, securities, over-the-counter securities and options, bank swaps, FOREX and government securities dealers among others. A partial fix in the form of a transfer of a portion of the CFTC's jurisdiction will not strength U.S. markets or properly position this country among the world's financial centers.

SEC Commissioner Mary Schapiro has recently pointed out that a partial transfer would leave a "demoralized and weakened CFTC" in its wake.

An unbiased and highly knowledgeable observer, SEC Commissioner Edward H. Fleischman, has put it best. He believes that the competition between the SEC and CFTC has led to more innovation rather than less. He questions whether the SEC could actually regulate the futures markets without strangling them. And, he ventures that if the SEC had the jurisdiction it would do nothing to protect capital markets that the CFTC has not already done.

Recently the most perverse argument we have yet encountered in favor of the recommended legislative changes has surfaced. This argument suggests that by making the proposed changes we will somehow prevent the next market crash, and conversely, should there be one, it will surely be the fault of futures and options if the recommended change did not occur.

Of all the arguments we have heard this is the most inflammatory, fallacious, and one that we find most abhorrent. It is in the nature of false advertising since it attempts to blame futures and options markets for whatever else may ever occur in the future. One cannot help but ponder the motive of those who make this argument since it sounds like an attempt to deflect away from themselves any and all prospective blame in favor of some misdirected source.

Federal Reserve Chairman Greenspan responded to this very issue when it was raised by the Chairman of this Senate Banking Securities Subcommittee on March 29, 1990.

> I would scarcely want to argue that (legislative) action is mandatory, because if action fails, that the system would be put in jeopardy. I don't believe that. I think that if there is a major market reaction, it is likely to occur with or without changes that we're talking about and I'm not certain the extent to which the types of changes we're talking about would make all that much substantial difference in how the particular market break worked its way through the system.

This is not to say market breaks will not occur. Indeed, without attempting to predict the market direction one way or another, there are abundant reasons why the market could decline, even precipitously. One need only pick up the daily newspaper to find that many commentators believe that, recent market record highs notwithstanding, the stock market has ignored important fundamental economics -- which cannot forever be ignored -- and may be in for a rough time.

And now, please add to all the known market woes yet another danger of recent vintage. As reported in the July 8, 1990 Sunday *New York Times*, recent suggestions for a transfer tax on the sale of securities, options or futures, are the very fuel to cause another major market break. Says AMEX Chairman James Jones, "I can't believe, that Congress would do that and take the very high risk of a new break in the stock market." We concur.

Indeed, should the market occasion a fall, we submit it will not be caused by the markets themselves, be it securities or futures, nor will the cause be the consequence of a regulatory gap or separate jurisdiction over equity derivatives. The ultimate direction of the market is determined by fundamental factors and little else.

Allow me therefore to conclude with this quote from SEC Commissioner Edward H. Fleischman: "...you tell me what we (the SEC) would do differently...I venture to say nothing."

Senator DODD. Thank you very much, Leo.

Mr. Mahlmann, we appreciate your being here with us, as well.

STATEMENT OF KARSTEN MAHLMANN, CHAIRMAN, CHICAGO BOARD OF TRADE

Mr. MAHLMANN. Thank you, Mr. Chairman, members of the committee.

I'm Karsten Mahlmann, chairman of the Chicago Board of Trade. With me today is William O'Connor, vice chairman, and Thomas Donovan, the president and chief executive officer.

In the past few months, a good deal of time and attention has been devoted to three issues: regulatory jurisdiction over stock index futures; stock index futures margins; and CFTC exclusive jurisdiction. My challenge this morning is to address those issues in the brief time allotted.

To expedite matters, I thought it would be best to review with you, the key questions that keep coming up in this debate and the answers that have been provided by presumably objective third parties.

Question 1. Are stock index futures useful economic instruments or mere gambling devices? The Chairman of the SEC, Richard Breeden, stated: "I would want to make very clear that we think financial futures markets, and the stock index market in particular, are extremely valuable overall capital markets.

Question 2. Is the Commodity Futures Trading Commission doing a good job regulating stock index futures? Under Secretary of the Treasury, Robert Glauber, testified before the Securities Subcommittee of this committee, the CFTC is doing a good job under difficult circumstances.

Question 3. Is the SEC better than the CFTC? Chairman Breeden addressed this issue before the Securities Subcommittee and said:

> I would like to stress one thing. In my opinion, the commissioners and staff of the Commodity Futures Trading Commission are dedicated professionals. They have worked diligently to achieve the goals Congress has set for regulation of futures markets. The SEC commissioners and staff are not better or smarter than their CFTC counterparts.

Question 4. Would shifting stock index futures jurisdiction to the SEC stop price volatility and sharp declines in the stock market? Senator Richard Luger stated:

> That's irresponsible logic when you have one academic study after another showing very very little correlation in terms of the volatility argument.

The Chairman of the Federal Reserve Board, Alan Greenspan, also answered the argument that giving the SEC stock index futures jurisdiction would prevent another market break by saying:

> I don't believe that. I think that if there is a major market reaction it is likely to occur with or without changes that we're talking about, and I'm not certain the extent to which the types of changes we're talking about would make all that much substantial difference in how the particular market break worked its way through the system.

Question 5. What would happen if the SEC assumed stock index futures jurisdiction? The Federal Reserve Board Governor Wayne Angell has observed:

> If the SEC were to regulate certain financial futures, it might impose dual, possibly inconsistent, regulatory standards on exchanges and on market participants who trade across a wide variety of financial commodity futures.

Question 6. In periods of market stress, what are the real problems? Governor Angell again:

> The SEC has failed to point out that the specialist system on the New York Stock Exchange has been a major obstacle to market clearing forces in times of stress; divergence between the Chicago stock market index and the New York Stock Exchange averages are undoubtedly more an indication of improvement needs on the spot than on the futures market.

Question 7. Are index futures and program trading keeping the little guy out of the market? Mr. Melamed referred to the New York Stock Exchange Study, and economist Floyd Norris concluded:

> Brokers say their customers are petrified by program trading, but customers, themselves, say they are much more worried about the honesty of brokers. More than half of those who responded, 58 percent, said they were very concerned with the honesty and ethics of brokers. Any program trading? Only 11 percent of the shareholders said they were very concerned about that. Of the 13 categories in the survey, program trading drew the least concern except for index futures and options of trading, which was of great concern to just 9 percent.

Question 8. As a matter of regulatory policy, is it better to rely upon coordination among two specialized regulators or to concentrate broader powers in the hands of a single agency? Chairman Greenspan and Chairman Breeden both oppose concentrating broader powers in a single agency. Chairman Greenspan:

> In addition to the potential management difficulties of a large organization, there is the risk that bureaucratic inertia in a larger agency could be an impediment to the process of innovation.

In the banking area, Chairman Breeden recently observed:

> Oversight by two or more specialized regulators would be more efficient and less intrusive than expansive substantive regulation by a single agency not familiar with many areas of the firm's operations.

Question 9. If the SEC had the power over stock index futures, what would it do with it? SEC Commissioner Fleischman's answer:

> We really don't understand these markets, it is a different world. You tell me what we, the SEC, would do differently. I would venture to say, nothing.

Question 10. Do stock index futures margins make the stock market more volatile? Chairman Greenspan testified:

> All of the analytical tools we have brought to bear has failed to find any such relationship.

Question 11. What would happen if stock index futures margins were raised above the levels necessary to prevent defaults in the clearing system? Chairman Greenspan, again, explained that raising margins:

> To levels well above those necessary for prudential purposes could substantially reduce futures market liquidity or drive business offshore.

Question 14. Has separate CFTC–SEC jurisdiction over equity products thwarted innovation? As Chairman Greenspan recently testified before the House Telecommunications Subcommittee:

> We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments, our financial markets have been the most inno-

vative in the world, with many of the new products spurred by the introduction of index futures and other futures.

Question 15. Did the Court's opinion in the Index Participants case define a futures contract so broadly that the CFTC's exclusive jurisdiction could invade traditional areas of concern to other agencies? The Solicitor General of the United States advised the Supreme Court:

> We do not believe that the opinion augurs a wholesale expansion of CFTC jurisdiction at the expense of other agencies. The opinion, itself, suggests limiting principles, and other limiting principles are likely to be developed.

Mr. Chairman, these questions have been the focal point of this debate for months. The answers provided by other observers all point to one conclusion: no statutory changes are needed.

Some have argued that we should revamp our regulatory structure to follow that of the Japanese and other foreign markets. The best answer to that argument appeared in a recent article in the Japan Economic Journal. The article explains that the Japanese financial community is dissatisfied with their splintered regulation of futures markets:

> Participants in futures trading say that Japan should have a single controlling body for the futures markets, similar to the CFTC of the United States.

Thank you, Mr. Chairman. I stand ready to answer questions.

[The complete prepared statement of Karsten Mahlmann follows:]

TESTIMONY OF

KARSTEN MAHLMANN

CHAIRMAN

CHICAGO BOARD OF TRADE

BEFORE THE
SENATE COMMITTEE
ON BANKING, HOUSING,
AND URBAN AFFAIRS

July 24, 1990

Mr. Chairman and members of the Committee, I am Karsten Mahlmann, Chairman of the Chicago Board of Trade. In the past few months, a good deal of time and attention has been devoted to three issues: (1) regulatory jurisdiction over stock index futures; (2) stock index futures margins; and (3) CFTC exclusive jurisdiction.

My challenge this morning is to address those issues in the brief time allotted. To expedite matters, I thought it would be best to review with you the key questions that keep coming up in this debate and the answers that have been provided by presumably objective third parties.

1. Are stock index futures useful economic instruments or mere gambling devices?

The Chairman of the Securities and Exchange Commission, Richard Breeden, has stated:

> "I would want to make very clear that we think the financial futures markets and the stock index market in particular . . . are extremely valuable to the overall capital markets."

Transcript of Hearing Before the Senate Committee on Agriculture, Nutrition, and Forestry, May 8, 1990, p. 102.

2. Is the Commodity Futures Trading Commission doing a good job regulating stock index futures?

On March 29, 1990, Under Secretary of the Treasury Robert Glauber testified before the Securities Subcommittee of this Committee (p. 13) that: "the CFTC . . . [is] doing a good job under difficult circumstances."

3. Is the SEC better than the CFTC?

On March 29, SEC Chairman Breeden addressed this issue before the Securities Subcommittee and stated (p. 2):

> "I would like to stress one thing. In my opinion, the Commissioners and staff of the Commodity Futures Trading Commission("CFTC") are dedicated professionals, and they have worked diligently to achieve the goals Congress has set for regulation of the futures markets. The SEC Commissioners and staff are not better, or smarter, than their CFTC counterparts."

4. Would shifting stock index futures jurisdiction to the SEC stop price volatility and sharp declines in the stock market?

Senator Richard Lugar has stated:

> "that is irresponsible logic when you have one academic study after another showing very, very little correlation in terms of the volatility argument."

Transcript of May 8, 1990, Senate Agriculture Committee Hearing, p. 69.

The Chairman of the Federal Reserve Board, Alan Greenspan, also answered the argument that giving the SEC stock index futures jurisdiction would prevent another market break.

> "I don't believe that. I think that if there is a major market reaction, it is likely to occur with or without changes that we're talking about and I'm not certain the extent to which the types of changes we're talking about would make all that much substantial difference in how the particular market break worked its way through the system."

Transcript of Hearing Before the Securities Subcommittee on March 29, 1990, p. 51.

5. What would happen if the SEC assumed stock index futures jurisdiction?

Federal Reserve Board Governor, Wayne Angell, has observed:

> "if the SEC were to regulate certain financial futures, it might impose dual, possibly inconsistent, regulatory standards on the exchanges and on market participants who trade across a wide array of financial and commodity futures."

Letter from Governor Angell to the American Farm Bureau Federation, April 10, 1990.

6. In periods of market stress, what are the real problems?

Governor Angell again has observed:

> "[T]he SEC has failed to point out that the specialist system on the New York Stock Exchange has been a major obstacle to market clearing forces in times of stress; divergence between the Chicago stock market index and the NYSE averages are undoubtedly more an indication of improvement needs on the spot than on the futures market."

Id.

7. Are index futures and program trading keeping the little guy out of the stock market?

In describing a recent New York Stock Exchange Study on this point, a New York Times columnist concluded:

> "Brokers say their customers are petrified by program trading, but the customers themselves say they are much more worried about the honesty of brokers.
>
> . . . .
>
> More than half of those who responded, 58 percent, said they were very concerned with the 'honesty and ethics of brokers'. . . .

> And program trading? Only 11 percent of shareholders said they were very concerned about that. Of the 13 categories in the survey, program trading drew the least concern except for index futures and options trading, which was of great concern to just 9 percent."

Floyd Norris, Common Worry: Brokers' Honesty, New York Times, p. D10 (June 13, 1990).

8. As a matter of regulatory policy, is it better to rely upon coordination among two specialized regulators or to concentrate broader powers in the hands of a single agency?

Chairman Greenspan and Chairman Breeden both oppose concentrating broader powers in a single agency. Chairman Greenspan has stated:

> "In addition to the potential management difficulties of a large organization, there is the risk that bureaucratic inertia in a larger agency could be an impediment to the process of innovation."

Chairman Greenspan's Testimony Before the Subcommittee on Telecommunications and Finance of the House Energy and Commerce Committee, May 29, 1990, p. 3.

In the banking area, Chairman Breeden recently observed:

> "[O]versight by two or more specialized regulators would be more efficient and less intrusive than expansive substantive regulation by a single agency not familiar with many areas of the firm's operations."

Chairman Breeden's Testimony Before the Subcommittee on Telecommunications and Finance of the House Energy and Commerce Committee, May 27, 1990, p. 22.

9. If the SEC had the power over stock index futures, what would it do with it?

- SEC Commissioner Edward Fleischman has answered:

> "We really don't understand these markets, it is a different world. . . . You tell me what we [the SEC] would do differently. I would venture to say nothing."

Nathaniel C. Nash, The Battle Over Regulation of the Futures Markets, New York Times, p. 12 Sec. 3 (March 15, 1990).

10. On the margin issue, do stock index futures margins make the stock market more volatile?

Chairman Greenspan has testified that "[a]ll of the analytical tools we have brought to bear has failed to find any such relationship." Transcript of Hearing Before Securities Subcommittee on March 29, 1990, p. 28.

11. What would happen if stock index futures margins were raised above the level necessary to prevent defaults in the clearing system?

Chairman Greenspan has explained that raising margins "to levels well above those necessary for prudential purposes could substantially reduce futures market liquidity or drive business offshore." Chairman Greenspan's Testimony Before the Subcommittee on Telecommunications and Finance of the House Energy and Commerce Committee, May 24, 1990, p. 3.

12. What would happen if the government set stock index futures margin?

In a 1988 report (pp. 2-3), the Subcommittee on Domestic Monetary Policy of the House Banking Committee concluded:

> "Any federal agency directed to set futures margins would likely be driven, by the nature of the incentives it faces, to set margins higher than needed to protect financial integrity, thereby imposing excessive costs on futures market traders, contracting market liquidity and impairing market efficiency. . . . Imposing substantial costs on traders through higher margins would drive the larger hedgers to seek other outlets for risk transference. . . . Most will eventually turn to foreign futures markets. . . No public purpose could possibly be served by driving the large institutional users of our own well-established and efficient exchanges into foreign hands."

13. What about the exchanges' track record in setting margins?

The House Subcommittee report also concludes (page 2):

> "The ability of the futures exchanges to set their own margins appropriately, to ensure financial performance, has been amply demonstrated. . . . Various studies and reports on the [1987] market collapse, including the Brady Commission Report, found that futures margins operated soundly and effectively to protect the financial integrity of the markets. No federal agency could improve on that record."

Id.

14. Has separate CFTC-SEC jurisdiction over equity products thwarted innovation?

As Chairman Greenspan recently testified before the House Telecommunications Subcommittee (page 11):

> "We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments, our financial markets have been the most innovative in the world, with many of the new products spurred by the introduction of index futures and other futures."

15. Did the court's opinion in the Index Participations case define a futures contract so broadly that the CFTC's exclusive jurisdiction could invade traditional areas of concern to other agencies?

The Solicitor General of the United States advised the Supreme Court:

> "we do not believe that the opinion augurs a wholesale expansion of CFTC jurisdiction at the expense of other agencies. The opinion itself suggests limiting principles, and other limiting principles are likely to be developed."

Brief for the Federal Respondent in Opposition in Nos. 89-1502, 89-1503, and 89-1484, p. 8.

16. Did the IPs decision prevent IPs from being traded in the United States?

Again, the Solicitor General's brief provides the answer:

> "[A]llocating jurisdiction over IPs to the CFTC did not doom that product not to be traded; the CFTC proposed to cooperate with the SEC in authorizing the trading of IPs as futures contracts."

Id. at 26 n.33.

* * *

Mr. Chairman, these questions have been the focal point of this debate for many months. The answers provided by other observers all point to one conclusion -- no statutory changes are needed.

Some have argued that we should revamp our regulatory structure to follow that of the Japanese and other foreign markets. The best answer to that argument appeared in a recent article in the Japan Economic Journal. The article explains that the Japanese financial community is dissatisfied with their splintered regulation of futures markets: "Participants in futures trading . . . say that Japan should have a single controlling body for the futures market, similar to the CFTC of the U.S."

This article underscores dramatically that the world looks to U.S. futures markets and regulation as the models to emulate, while we bicker among ourselves in a legislative turf battle that sets exchange against exchange and regulator against regulator. Rather than continue this unwarranted, intramural squabble that can only aid our foreign competition, the regulators and the exchanges should begin to address cooperatively what steps we should be taking in order to maintain our markets as the best in the world. Our markets and the public we serve deserve at least that much from all of us.

SUMMARY OF TESTIMONY OF KARSTEN MAHLMANN, CHAIRMAN, CHICAGO BOARD OF TRADE, BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

JULY 24, 1990

The Capital Markets Competition, Stability and Fairness Act of 1990 is a bad idea poorly executed. All three areas addressed by the bill -- CFTC jurisdiction over stock index futures, stock index futures margins and CFTC exclusive jurisdiction -- reflect sound congressional policy judgments embodied in existing law. No statutory changes in these areas are warranted.

1. Stock Index Futures Jurisdiction: The bill would set a dangerous and illogical precedent by combining regulation of a futures market (stock index futures) with the cash market (the stock market). The Treasury bill would force the SEC to create a "mini-CFTC," a completely unnecessary expenditure of government resources. SEC regulation of stock index futures will not stop market volatility or bring retail investors back to the stock market. A recent investor survey conducted by the New York Stock Exchange shows that the honesty of their brokers, not program trading or the futures market, is the primary concern of these investors. See, Floyd Norris, Common Worry: Brokers' Honesty, New York Times, p. D10 (June 13, 1990). At the same time, by calling for duplicative or conflicting CFTC and SEC regulation of futures markets, the Treasury's bill imposes a heavy burden of increased costs on all futures market participants. The bill, therefore, will jeopardize the U.S. futures markets preeminent competitive position in the world.

2. Stock Index Futures Margins: Futures margins do not cause stock market price volatility. As set by the exchanges, margins serve their proper prudential purpose by ensuring the financial integrity of futures trading. All parties agree that differences in purpose, timing of payment and anticipated price changes support having considerably lower margin levels for futures than stock. The existing margin levels of 11-15% of contract value (as set by the Chicago exchanges) are more than adequate; no one has challenged these levels as too low. Shifting margin authority to the government -- beyond the CFTC's existing emergency and jaw-boning powers -- is not justified by the record.

3. CFTC Exclusive Jurisdiction: Far from stifling innovation and competition, CFTC exclusive jurisdiction makes certain that all futures contracts and related options will be subject to the regulatory scheme designed by Congress for that form of commercial activity. The record shows that CFTC exclusive jurisdiction historically has promoted innovation and resolved inter-agency disputes, just as Congress intended. The SEC has its own exclusive jurisdiction -- but the Treasury never claims the SEC's authority stifles competition or innovation and the Treasury's bill even attempts to expand SEC exclusive jurisdiction. The Index Participations case has been repeatedly misrepresented; IPs could be traded in the U.S. today under CFTC jurisdiction, but no securities exchange wants to submit to CFTC jurisdiction as required by law. The entire exclusivity debate stems from a misunderstanding and misapplication of the concept of "futurity" under the Commodity Exchange Act. Current law has established a set of workable principles, akin to those

under federal securities law, for distinguishing instruments subject to CFTC jurisdiction from those that are not. Accordingly, in responding to the charge that CFTC exclusive jurisdiction "chills" innovation, the Solicitor General has responded: "hard evidence in support of that proposition is difficult to come by." Brief for the Federal Respondent in Opposition at 8, Chicago Mercantile Exchange v. SEC, 883 F.2d 537 (7th Cir. 1989) (Nos. 89-1502, 89-1503, 89-1484), cert. denied. (U.S. June 18, 1980).

4. The Treasury Bill Misses Each of Its Targets: Each of these three points addresses what the Treasury bill tries to do. Through lack of experience in and understanding of futures regulation (or a conscious, inexplicable policy decision), the Treasury bill actually (1) gives the SEC jurisdiction over virtually all futures trading, including agricultural futures and (2) deregulates financial and stock index futures trading directly and all other futures indirectly. Thus, the bill gives the SEC more authority than the Treasury probably realizes in one provision and then effectively repeals it in the next. Congress should not have any confidence in a legislative recommendation that adopts this erratic approach, one the bill's sponsors either don't comprehend or refuse to admit.

PREPARED WRITTEN STATEMENT OF

KARSTEN MAHLMANN

CHAIRMAN

CHICAGO BOARD OF TRADE

BEFORE THE

SENATE COMMITTEE

ON BANKING, HOUSING,

AND URBAN AFFAIRS

July 24, 1990

Mr. Chairman and members of the Committee, my name is Karsten Mahlmann. I am Chairman of the Chicago Board of Trade. During my four year tenure as Chairman, I have been privileged to testify before many congressional committees on a wide variety of subjects. Frankly, some of these appearances I have enjoyed more than others. But none have I looked forward to more than today.

For months, I have watched and listened while others have presented their case for drastic changes in futures regulation and jurisdiction, always couching them as "minimizing disruption" or creating the "least disturbance." That case, however, is based upon factual inaccuracies, misleading rhetoric and a stubborn misunderstanding of existing law. I welcome the opportunity to respond.

On June 15, 1990, Secretary of the Treasury Nicholas Brady sent each member of the Senate a letter setting forth the rationale for the Capital Markets Competition, Stability and Fairness Act of 1990. I have great respect for Secretary Brady and the high office he holds. Nevertheless, I must tell you that the materials each of you received and the legislation he proposed are riddled with errors and illogical conclusions. Let us examine the most significant problems.

"One Market"

The Treasury says that since the stock index futures market is related to the stock market, both markets should have the same regulator. If adopted, this regulatory principle would mandate a complete overhaul of all futures regulation because every futures market is related to its underlying cash market. Under the Treasury's view, each futures market and its related cash market should be regulated by the same entity: the Department of Agriculture should regulate agriculture futures; the Treasury should regulate Treasury and currency futures, the Energy Department should regulate energy futures, and so on. In this scheme, the Commodity Futures Trading Commission would be replaced by "mini-CFTC's" within each of these agencies at a price to the taxpayers and market users that would be enormous and wasteful. The current "regulation by function" approach is much wiser, as Congress recognized many years ago.

In the June 15 letter and attached materials, Treasury asserts that "the interaction of the recently-created stock index futures with stocks and stock options has contributed to major market disruptions" and "violent downspikes" in the stock market. Treasury did not tell you the long term record of this interaction. Stock index futures trading began over eight years ago on February 24, 1982. At that time, the Dow Jones Industrial Average was 826.7. On Monday, July 9th ~~of this week~~, the Dow closed at 2914, an increase of well over 300%. Stock index futures cannot be said to have ruined the stock market. Indeed, on May 8, 1990, the Chairman of the Securities and Exchange Commission testified that "the financial futures markets and the stock index market in particular . . . are extremely valuable to the overall capital markets." *Unofficial Transcript of Hearing Before the Senate Committee on Agriculture, Nutrition and Forestry, May 8, 1990*, p. 102.

Stock index futures do affect the stock market, through index arbitrage and enhanced hedging opportunities that promote investment in equity securities. But other financial markets also interact with the stock market. Market experts frequently cite interest rates and the value of the dollar as major factors influencing the stock market. Under the

Treasury's "one market" logic, the Securities and Exchange Commission should set interest rates and regulate the currency markets because both affect stock prices.

Of course, the Treasury proposal does not adopt this view because, they would say, the interest rate and currency markets are different from the stock market. So is the stock index futures market. The fact that one market affects another market is no basis for lumping all inter-related, but different, financial markets into one regulatory scheme.

"Dangerously Low Futures Margin"

The Treasury Department complains that "[f]utures traders can control so great an amount of stock with so little of their own money." Letter dated June 15, Attached materials, p. 2. The Treasury misunderstands futures. Traders in a stock index futures contract control no stock. They do not receive shares of stock; they do not earn dividends on the stock; they cannot vote the stock; and they cannot borrow against the stock. A stock index futures contract does not convey ownership in any stock; instead, a futures contract today gives market participants the ability to hedge against, or speculate on, future price changes in a stock index that reflects the value of the whole market.

The heart of the Treasury's complaint is the volatility issue -- futures margins, according to Treasury, cause stock prices to be volatile. Their theory is that low futures margins create "enormous selling pressure on the stock market-great enough to punch a hole in the fabric of the financial system." Id. But markets move in two directions, so if this were true, low futures margins also would sometimes "concentrate great buying pressure" on the stock market, pushing prices higher. The Treasury never mentions this, however.

In any event, is Treasury right? Do stock index futures margins cause stock price volatility? Federal Reserve Board Chairman Alan Greenspan joins the consensus of the academic community to answer, emphatically, no. In his words,

> "All of the analytical tools we have brought to bear has failed to find any such relationship."

Testimony of Alan Greenspan, Chairman of the Federal Reserve Before the Subcomm. on Securities of the Senate Banking, Housing, and Urban Affairs Comm., March 29, 1990, p. 28.

Treasury also mistakenly claims that a trader with $50,000 in cash could control almost $2,000,0000 in stock through stock index futures. Again, the trader controls no stock. The Treasury's example is puzzling for yet another reason. Treasury claims the answer to all of the problems it sees in the stock index futures market is to replace the CFTC with the SEC as the regulator of stock index futures. But the SEC already regulates the stock index options market, where any member of the public could, in the Treasury's view, "control" almost $4,000,000 of stock by paying premiums of only $5,000 on a long shot, out-of-the-money option. Ironically, Treasury never complains about the super-leverage afforded by instruments the SEC regulates.

Leverage on S&P 100 Options

As explained in the 1988 Brady Commission Report (p. VI-19), "a stock index option is a leveraged, derivative trading vehicle that allows an investor to realize cash profits from favorable price movements of a specified portfolio or index of securities." The Brady

Report does not say how much leverage is available through stock index options. The chart on page 6 answers this question for the most heavily traded stock index option (the S&P 100 option) on a recent randomly selected date, June 19, 1990.

Some basic background may be helpful in analyzing this chart. The S&P 100 option is an option based upon an index of 100 stocks known as the S&P 100 Index or the OEX. At the close of trading on June 19, 1990, the value of the S&P 100 Index was 341.86, as computed by Standard & Poors. Under exchange rules, the value of the option on the S&P 100 Index is determined by multiplying $100 times the Index value (here 341.86). Thus, at the close of trading on June 19, the value of the S&P 100 option contract was $34,186.

Options involve two parties -- the options purchaser and the options writer (seller). The purchaser pays the writer (seller) a premium for the right, but not the obligation, to buy (call) or sell (put) something (a stock or stock index) at an established price (the strike price) at a future date (the expiration date of the option). In call options on a stock index like those covered in the chart, the purchasers hope the value of the index will increase above the strike price, thereby enabling the purchasers to realize cash profits.

Exchanges list various strike prices for these options, as shown in the first column of the chart. Options trading volume typically is concentrated in the strike prices closest to the value of the index (which was 341.86 on June 19) -- strike prices 340, 345 and 355 in the chart. Those strike prices represented 86% of all trading in S&P 100 call options on June 19. The reason for this concentration is, as the premiums listed in the chart show, call options which are in-the-money (strike price is less than the index value) are more expensive for buyers than options out-of-the money (strike price is more than index value).

Strike Price	July '90 Call Volume	Premium For July '90 Call Option	Premium as a % of Contract Value
315	2	$2,800	8.2%
325	1,406	2,025	5.9%
335	2,148	1,175	3.4%
340	10,867	825	2.4%
345	20,235	525	1.5%
355	9,763	169	0.5%
365	2,845	44	0.1%

Some have charged that 2% leverage on a stock index futures contract is financially irresponsible. This 2% leverage figure is calculated by taking the amount a member of the public would have to pay in order to establish a stock index futures position (the margin payment) and determining what percentage of the value of the futures contract that payment represents. (The 2% figure is now inaccurate; at current levels, margins on stock index futures contracts traded on the Chicago exchanges would be 11-15% of the value of the futures contract.) Using the same "leverage" approach to stock index options, the chart shows that the leverage available for over 90% of the S&P 100 call options traded on June 19 was, on average, well below 2%. If 2% leverage is a problem, why hasn't the SEC done anything about the options it already regulates?

Futures Margin v. Stock Margin: The Differences in Concept and Practice

All parties to this debate agree that futures margin and stock margin are fundamentally different payments that, by historical accident, share the same name. Futures margin is a performance bond. Stock margin is a down-payment on a loan. Futures margin must be paid before a futures contract may be bought. Stock margin may be paid up to seven business days after a stock is purchased. Futures margin is used daily, or even during the trading day, to cover market losses, if any. Stock margin is not. Stock index futures margin is designed to cover one day's expected volatility in a broad-based stock index. Stock maintenance margin is necessarily higher because the volatility in a single stock price is, historically, 500% greater than in a market-wide index.

Based on these differences, all parties to this debate have conceded at one time or another that futures margin should be much lower than stock margin. The question is how much lower and who should decide. On the Chicago exchanges, stock index futures margins now are set at 11-15% of contract value; no one has challenged this exchange-set level, except those who contend it is too high.

The Greenspan Margin Principles

In the context of these facts about margin on stock index futures, the views of Federal Reserve Board Chairman Greenspan must be considered. In summary, Chairman Greenspan's views are:

1) Stock index futures margins as set by the exchanges are fine for prudential purposes, that is to prevent defaults in the clearing and settlement system;

2) Raising margins "to levels well above those necessary for prudential purposes could substantially reduce futures market liquidity or drive business offshore";

3) When futures exchanges raise margins during periods of extraordinary price volatility, "it tends to compound already substantial liquidity pressures on" market participants, lenders, and the payment and clearing systems;

4) Therefore "somewhat higher margin levels on stock index futures would obviate the need to raise them in a crisis."

Testimony of Alan Greenspan, March 29, 1990, pp. 2-4.

The Board of Trade agrees with these principles for stock index futures margin, with one caveat. As Chairman Greenspan well knows, even if exchanges do not raise margins in periods of extraordinary price volatility, there is a good chance that brokerage houses will decide unilaterally to raise margins to protect themselves against the increased risk of default by their customers. So the "substantial liquidity pressures" Chairman Greenspan seeks to avoid may occur irrespective of exchange-set margin levels.

On the issue of who should set margin levels, Chairman Greenspan concludes that the futures exchanges "should continue to have primary responsibility for developing and refining margin policies." Testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve, Before the Subcomm. on Telecommunications and Finance of the House Committee on Energy and Commerce, May 24, 1990, p. 4. We agree. Setting margins involves a delicate and complex balance of factors relating to market efficiency, market integrity and financial integrity, as Chairman Greenspan's principles show. If margins are too high, they could choke the market's liquidity, aid foreign competition, spur market volatility and discourage hedging of price risks and, therefore, investment in equity securities. If margins are too low, defaults could occur. Exchanges consider and resolve this tenuous balance every business day.

Some want to give the government responsibility for setting that balance. I say, you cannot have it both ways. If the exchanges are to have "primary responsibility" for margins, a policy Chairman Greenspan supports, the government cannot be authorized to reverse and reset the balance established by the exchanges. Any government authority over margins, beyond the CFTC's existing emergency and jaw-boning powers, gives the government "primary responsibility" for setting margins and demotes the exchanges to a secondary role.

Is that demotion warranted by the record? No. Have futures margins caused stock volatility? No. Could the government do a better job of setting the margin balance? No. Consider the following objective conclusion from the 1988 margin study conducted by the Subcommittee on Domestic Monetary Policy of the House Committee on Banking, Finance and Urban Affairs (page 2):

> "Various studies and reports on the market collapse, including the Brady Commission Report, found that futures margins operated soundly and effectively to protect the financial integrity of the markets. No federal agency could improve on that record."

"Short Selling"

The Treasury complains that stock index futures permit an "evasion of short selling restrictions." Letter dated June 15, 1990 from Secretary of the Treasury, Nicholas Brady, Attached materials, page 2. This complaint evidences a quaint, but outdated, view of our financial markets. The short selling restriction prevents an investor from selling a stock he does not have unless the last trade in the stock showed a price increase or "up tick." If applied to stock index futures, this principle would end the futures market; unless the last trade in all five hundred stocks in the S&P 500 Index reflected a price increase, no trader could sell (or go short) the stock index futures. No derivative market could fulfill its hedging or price discovery functions under this restriction, as even the SEC has acknowledged. After all, the SEC allows investors to buy puts and sell calls on stock index options even in a declining market. The Treasury has never called that activity an "evasion of short selling restrictions." Why the double standard?

"Barriers To Innovation"

Under existing law, all futures contracts must be regulated exclusively by the CFTC. The Treasury wants to repeal this requirement because it "stifles innovation." The Treasury misperceives the rationale for, and record of, CFTC exclusive jurisdiction.

In 1974, Congress gave the CFTC exclusive jurisdiction because it correctly recognized that other federal agencies might lay claim to the new forms of futures contracts then on the financial horizon. Congress intended CFTC exclusive jurisdiction to be a statutory tie-breaker that would help the CFTC avoid protracted disputes over its regulatory territory with other agencies that already had more than enough of their own. At the same time, by mandating that the CFTC would regulate all futures contracts, Congress prevented duplicative and even conflicting regulation from thwarting these new financial innovations, while promoting fair and even competition among all parties offering futures by requiring all parties to follow the same set of rules.

The exclusive jurisdiction provision is the provision of the Commodity Exchange Act that makes the statutory scheme work. Without it, the regulatory program established by Congress for all risk shifting instruments would become splintered among banking regulation, securities regulation and the Commodity Exchange Act. As a result, basic regulatory protections embodied in the CEA would be conveniently sidestepped by those offering futures or options contracts under banking or securities labels. In other words, efficient and unified regulation of the congressionally recognized risk shifting function would be unachievable.

The system Congress designed has worked well. CFTC-SEC jurisdictional disputes have been kept to a minimum, while responsible financial innovations have flourished. Indeed, Chairman Greenspan has observed that under "the existing system of split jurisdiction over financial instruments, our financial markets have been the most innovative in the world, with many of the new products spurred by the introduction of index futures and other futures." Testimony of Alan Greenspan, May 24, 1990, p. 11.

As the Treasury well knows, in a sense all regulation stifles innovation. For example, assume that the Chicago Board of Trade creates a new instrument that looks like an "option on a stock index." Because we want our new instrument to be regulated by the CFTC, we call it a Limited Risk Index Futures Contract. You and I both know that as soon as we announce our new product, we would receive a call from the SEC saying, "Not so fast, Board of Trade. In 1982, Congress gave the SEC exclusive jurisdiction over stock index options. Your new option dressed in futures clothing, doesn't fool us. You cannot trade it without complying with federal securities laws. We don't care what the CFTC says."

Would the SEC be stifling innovation? Yes. Would they be exercising exclusive jurisdiction granted by statute? Yes. Has the Treasury recommended changing this requirement? No.

Why the logical inconsistency? Why is CFTC exclusive jurisdiction and regulation bad and SEC exclusive jurisdiction and regulation good? The answer is really quite simple. Our hypothetical new Board of Trade instrument is not purely hypothetical; it is exactly what some securities exchanges tried to do by dressing a stock index futures contract in the clothing of a security in order to avoid CFTC regulation. That was the Index Participations case. The courts quickly, not in "protracted litigation" as Treasury asserts, saw through this ruse and ruled that if the exchanges wanted to trade IPs, they had to submit to CFTC jurisdiction because IPs were, as a matter of economics and law, futures contracts. All this hand-wringing over innovation stems from that decision.

As the Solicitor General has recognized, "allocating jurisdiction over IPs to the CFTC did not doom that product not to be traded." Brief for the Federal Respondent in Opposition at 26 n.33, Chicago Mercantile Exchange v. SEC, 883 F.2d 537 (7th Cir. 1989) (Nos. 89-1502, 89-1503, 89-1484), cert. denied. (U.S. June 18, 1980). The CFTC would have approved IPs for trading. But none of the securities exchanges has sought CFTC approval. That business decision, not the law, is preventing IPs from being traded in the U.S.

The Treasury decries the absence of IPs trading in the U.S. and wants you to believe that IPs are now trading in Toronto. That is not true. Unlike an IP or other stock index futures contracts, the Toronto instrument is a unit trust, where the trust owns the actual shares. The SEC received a proposal for a similar product in 1988. To date, however, the SEC has not acted on that proposed innovative product (although some action in the foreseeable future has been rumored in the trade press).

The Treasury also claims that too much uncertainty surrounds the definition of a "futures contract" under the IPs decision. I am not a lawyer, but I have been advised that the IPs decision is based on the same principles the courts have used for decades in trying to resolve what is a "security" under federal securities laws. In both instances, the courts look to the "economic realities and purposes" of the transactions at issue. Both securities and futures therefore are defined flexibly to promote the policy goals Congress identified in enacting the respective statutes. If the Treasury believes these principles no longer serve our national interest, they should propose statutory amendments to redefine both "securities" and "futures." To date, they have failed to do so.

For its part, in testimony before this Committee's Securities Subcommittee, the SEC asked whether the "exclusivity provision promotes a strong U.S. financial system and competitive economy?" Testimony of Richard Breeden, Chairman, Securities and Exchange Commission Before the Subcomm. on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, March 29, 1990, p. 21. The answer is yes. If the CFTC's exclusive jurisdiction were to vanish, what would happen? The SEC and bank regulators could authorize trading in "securities" and "deposits" tied to commodity values that duplicate commodity futures and options. These commodity bonds or deposits would afford speculators and hedgers the same opportunity to speculate on or hedge against future commodity price changes as they now have with futures and options. There would be a difference, of course. The Commodity Exchange Act would not apply to these clone futures and options.

Is that bad? It is bad if you think it is important to have (1) speculative limits on all futures and options controlled by a single trader; (2) futures and options traded only on government-approved exchanges to avoid bucket shops; (3) an "economic purpose" test that applies to all futures and options so that instruments without a legitimate commercial purpose could not be traded; (4) an explicit prohibition against non-competitive pre-arranged trading; (5) emergency authority to address immediately major market disorders; (6) an express private right of action against exchanges for failing to enforce their rules; (7) a comprehensive market surveillance program including large trader reporting; and (8) a reparations program to speed customer recoveries on fraud claims. These requirements (and more) are embodied in the Commodity Exchange Act. (This array of regulatory mechanisms does not include the major reforms included in the pending CFTC reauthorization legislation.) The federal securities and banking laws do not contain comparable provisions (although pending legislation would afford the SEC CFTC-like emergency authority and large trader reporting surveillance). These requirements and protections would be eroded if the exclusive jurisdiction provision was repealed or amended as the SEC has suggested.

The SEC states that "[t]he general approach of 'functional regulation' would serve us well in this case." Testimony of Richard Breeden, March 29, 1990, p. 21. The SEC is right! Congress decided in 1922 that the risk shifting and price discovery function served by futures contracts deserved special regulatory treatment. To that end, today the Commodity Exchange Act provides a comprehensive regulatory scheme for derivative instruments. The securities and banking laws do not (although they serve other valid purposes). In the absence of the exclusive jurisdiction provision, regulatory fragmentation over derivative instruments would surely occur. This would increase the cost of doing business while sacrificing important regulatory protections. Our foreign competitors would love to see us adopt that formula.

In summary, the so-called barrier to innovation issue is a phony. If I want to sell an option on a security, I must comply with securities law like everyone else. If I want to sell a futures contract, I must comply with futures law like everyone else. I cannot chose to sell a stock option under CFTC jurisdiction or a future under SEC jurisdiction. Unless we repeal all regulatory requirements, barriers to innovation will remain and, as a businessman, I will have to adjust my innovative impulses to satisfy those barriers.

Where the Treasury Goes Wrong:
The Commodity Exchange Act and "Futurity"

In the materials he sent to you on June 15, Secretary Brady claims that the CFTC exclusive jurisdiction provision "has been interpreted to require than any non-exempt financial instrument with any degree of 'futurity' must be traded on a futures exchange." Similarly, on March 29, 1990, Undersecretary of the Treasury Robert Glauber contended before the Securities Subcommittee that existing law "currently requires exclusive CFTC regulation of any instrument that has any element of 'futurity.'" Testimony of Robert Glauber, March 29, 1990, p. 13. (Emphasis in original.) At the same hearing, Chairman Greenspan echoed this legal conclusion.

> "Under the Commodity Exchange Act, any commodity contract with an element of futurity cannot be entered into except on a CFTC-regulated exchange."

Chairman Greenspan Testimony, March 29, 1990 at 8.

SEC Chairman Richard Breeden also claimed the CFTC's exclusive jurisdiction threatened "even pure security, banking or insurance products that could be alleged to involve some minimal aspect of futurity. . . ." Testimony of Richard Breeden, March 29, 1990 at 8. None of these statements is accurate.

How the Commodity Exchange Act Works

As we have seen, Congress has vested exclusive jurisdiction in the CFTC to regulate trading in commodity futures and options. (7 U.S.C. § 2) Congress defined "commodity" to include basically "all goods and articles . . . and all services, rights or interest in which contracts for future delivery are presently or in the future dealt in. . . ." (7 U.S.C. § 2) Congress adopted this definition because a more narrow definition would allow some instruments to slip through the regulatory cracks, as had happened prior to 1974. Congress also described a futures contract to be: "a contract for the purchase or sale of a commodity for future delivery." (7 U.S.C. § 4(a)) All contracts fitting that description must be traded on a CFTC-designated exchange. Id.

The essence of the Glauber/Greenspan/Breeden "futurity" position is that a wide array of contracts are inadvertently covered by the statutory description of a futures contract. Their analysis overlooks the forward contract exemption. In that provision, Congress told us what "future delivery" does not mean in the statutory description of a futures contract -- "the term 'future delivery' . . . shall not include any sale of any cash commodity for deferred shipment or delivery." (7 U.S.C. § 2) This forward contract exemption serves to exclude from the statutory exchange-trading requirement most transactions that literally call for "future delivery" of a commodity.

What is Futurity?

Let's consider an example. Assume Mr. X wants to buy a car for his business. Mr. X goes to a car dealer, sees a car in the lot he likes, pays the purchase price and drives away in his new car. No one could claim this is a futures contract; there is no future delivery. This is called a cash market transaction.

Now, what if Mr. X goes to the dealer, finds a car he likes for his business, signs a purchase agreement, leaves a down payment, and agrees to receive future delivery of the car next week. Assuming a car is a "commodity," this is a futures contract in Undersecretary Glauber's view -- the car purchase has an unmistakable element of "futurity." Nevertheless, this car purchase is for "deferred delivery," so, by law, it is not a futures contract. The forward contract provision excludes this transaction from the futures definition.

What if we change the facts slightly. Mr. X visits the dealer and is unable to find a car on the lot that he likes. The dealer tells Mr. X not to worry; the dealer can have a car meeting Mr. X's specifications and business needs shipped to him in three months. Mr. X agrees and enters into a contract with the dealer (secured by some form of down payment) to pay a specified amount for the car upon shipment and delivery to Mr. X. Under Chairman Greenspan's description of the Commodity Exchange Act, the transaction has "an element of futurity," so it should be a futures contract. Right? Wrong. Again this transaction is covered by the forward contract exemption because Mr. X's contract calls for "deferred shipment and delivery."

What is a Futures Contract?

If these last transactions are not futures contracts, or "contracts . . . for future delivery" to use the statutory description, what is a futures contract? Consider one more example. Assume Mr. Y does not want to buy a new car now, but he does want either to (1) speculate on the future price of a car or (2) hedge against future price increases on a car he may want to buy for his business later. Mr. Y goes to his dealer who offers Mr. Y a standardized form contract for future delivery of a car in three months where the only contract term left open for Mr. Y is the price. The dealer explains to Mr. Y that 95% of the time this form contract is not used to make or take delivery on a car. Instead, because the contracts are standardized, these contracts can be offset in the future (but before the three months is up) against contracts held by other car speculators or hedgers. Through offset, Mr. Y will enjoy a profit or suffer a loss based upon future car price movements.

By now, Mr. Y is a bit confused. The dealer offers him the following example.

EXAMPLE #1

- On April 1, 1990, Mr. Y agrees to buy a car on July 1, 1990, at a price of $10,000 under the form contract.
- By May 1, 1990, the price for that model car on the "market" is $11,000.

- On May 1, 1990, Mr. Y agrees to sell that model car for $11,000 under the form contract, thereby offsetting (or cancelling out) his April 1, 1990, agreement and resulting in a net profit to Mr. Y of $1,000.

EXAMPLE #2

- On April 1, 1990, Mr. Y agrees to buy a car on July 1, 1990, at a price of $10,000 under the form contract.
- By May 1, 1990, the price for that model car on the "market" is $9,000.
- On May 1, 1990, Mr. Y agrees to sell that model car for $9,000 under the form contract, thereby offsetting his April 1, 1990, agreement and resulting in a net loss to Mr. Y of $1,000. (Of course, if Mr. Y actually wanted to own the car, he could buy it now for $9,000 (or $1,000 less than on April 1); Mr. Y's April 1 transaction ~~would have~~ been a hedge against future price increases.)

Futures v. Forwards

What distinguishes Mr. Y's form contracts, which are futures, from the forward contracts Mr. X entered into in the earlier examples? The basic distinctions are: (1) Mr. Y and virtually all other buyers or sellers of the dealer's form contracts did not intend to buy or sell a car through this transaction; rather, they wanted to speculate on or hedge against future car price changes; and (2) The dealer's form contracts were standardized to facilitate offsetting transactions (the means by which profits or losses are usually recognized).

While this example used cars, the same facts could be applied to any other "commodity," including a basket of stocks, Treasury Bonds, corn or soybeans. The Glauber/Greenspan/Breeden focus on "futurity" is thus misplaced. Many instruments have futurity but are not futures contracts. These non-futures with "futurity" are not subject to exclusive CFTC jurisdiction. The Commodity Exchange Act does not affect competition in such instruments in any way.

The Bill Itself: Misguided, Unfair and Anti-Competitive

My remarks thus far have concentrated on the Treasury Department's rationale for its legislation, rather than the legislation itself, because the bill, as drafted, does not do what the Treasury claims. Although Treasury intended the bill to "provide[ ] institutional safeguards for the individual investor," Letter dated June 15, 1990, the bill effectively repeals, at a minimum, all federal regulation of financial futures trading and even most regulation of stock index futures.

Section 4 of the bill accomplishes this repeal by stating and restating that a futures contract involving a "security" (like Treasury Bonds), or any foreign currency, is not subject to the Commodity Exchange Act unless the exchange on which the contract is traded elects to obtain CFTC approval as a "designated contract market." By not volunteering for CFTC regulation, therefore, an exchange could exempt itself from the Commodity Exchange Act. No other federal statute would provide a substitute regulatory scheme.

This loophole is either a major drafting error that reflects a failure to comprehend the statutory text Treasury is asking you to amend or a baffling effort to deregulate financial futures, which as a businessman, I guess I should welcome. My concern, however, is that I fear the former, not the latter, underlies this poorly executed proposal. Confirming this fear is another drafting error. The Treasury proposal could be read to give the SEC jurisdiction over every futures contract any exchange or firm trades so long as that exchange or firm trades stock index futures. Thus, the SEC would assume virtually all of the CFTC's powers, even for agricultural futures. The bill states this not once, but twice, in Sections 3(a) and 3(b).

The essence of what the Treasury bill tries to do is this. The SEC would be granted the CFTC's powers under the Commodity Exchange Act, but only for stock index futures and options thereon. The impact of this change on the stock market would be zero. The market still would go up and down, sometimes with great velocity due to technology, the role of institutions in the market and maybe even the government's fiscal or monetary policies.

The impact of this change on the futures markets will be a profound increase in the cost of doing business. Under the same regulatory charter, the CFTC and SEC will duplicate each other's efforts in many areas including registration, review of disciplinary actions, capital rules and reporting requirements. At the same time, the CFTC and the SEC can be expected to become dueling regulators, eager to show which agency is best at administering the same statute. This will lead inevitably to conflicting regulation of the futures markets. The result of this regulatory duplication and conflict is simple: it will cost more for us to conduct our business and we will spread that cost among market users in every segment of the business -- from grain elevator operators to pension funds. These increased costs will benefit only two groups as far as I can tell: the lawyers and our foreign competition. Treasury did not tell you that in its June 15 message, but you can depend on it.

Conclusion

One final thought. Secretary Brady's June 15 message to all Senators states:

> "[W]hen the Japanese set up their futures market a few years ago, after detailed study of the U.S. futures and stock market system, they specifically established regulation of stocks and stock index futures in one agency. We should too."

Letter dated June 15, 1990, Attached materials, p. 1.

Putting aside how wise it is for the leader in a industry, like the U.S. futures industry, to follow the less successful path of its competitors, you should know that if we try to shift to the Japanese system, when we get there, we may find the Japanese have adopted the very system we decided to change. On June 23, 1990, the Japan Economic Journal carried a story entitled -- "Bureaucratic Spats Stifle New Securities." (p. 36). The story describes the dissatisfaction in the Japanese financial community over their scheme of futures regulation: "Participants in futures trading . . . say that Japan should have a single controlling body for the futures market, similar to the CFTC of the U.S." Id. at 34.

The article underscores dramatically that the world looks to U.S. futures markets and regulation as a model to emulate, while we bicker among ourselves in a legislative turf battle that tarnishes that model rather than making it work better. Put simply, we do not need any statutory changes. If we need coordinated circuit breakers to halt market declines, let's do it now. If we need better audit trials for all markets and better CFTC-SEC cooperation to deal with alleged intermarket frontrunning, let's do it now. If we need to make each market's trading and clearing process faster and more efficient, let's do it now. But, whatever we do, let's work together to avoid a necessarily politicized range war that sets exchange against exchange and regulator against regulator. Our markets and the public we serve deserve at least that much from all of us.

Senator DODD. Thank you. We have a vote, and we'll go into a short recess here. A soon as Senator Riegle returns, or Senator Dixon, they can reconvene the hearing. We have about 4 minutes left on a vote on the floor. So we'll suspend here, and when we come back, Mr. Kleckner will be next.

[Recess.]

The CHAIRMAN. The committee will resume. I want to indicate that, while we are interrupted by these votes today, I've agreed with Senator Dodd that we will try to continue so that we can move along, because I want to get all the statements on the record and leave us plenty of time for questions as well.

We've been joined by Senator Shelby.

Senator Shelby, do you have any opening comments?

Senator SHELBY. Mr. Chairman, I have an opening statement that I'd ask that it be made part of the record. And, other than that, I just want to take a moment to welcome, as everyone else has, our distinguished panel. I look forward to hearing some of their testimony and also asking them some questions.

The CHAIRMAN. Very good.

My understanding, Mr. Mahlmann, is that you did finish your testimony. Is that correct?

Mr. MAHLMANN. Yes, I did.

The CHAIRMAN. Very good. Then I think we'll come right on down the table.

Mr. Wilmouth, we'll start with you next.

Mr. WILMOUTH. Thank you, Senator Riegle.

The CHAIRMAN. And why don't you pull that mike over so everyone in the back of the room can hear you as well.

STATEMENT OF ROBERT K. WILMOUTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Mr. WILMOUTH. Thank you very much, Senator.

I am Robert Wilmouth, president of National Futures Association. NFA is the congressionally authorized, self-funded, self-regulatory body for the futures industry. Among all the self-regulatory organizations in both the securities and futures industries, NFA's position is unique.

NFA operates no marketplace and engages in no commercial activity. Our sole reason for existence is customer protection.

I would like to comment briefly on the regulatory impact of the administration's bill, which would do critical damage to the futures professionals we regulate and, more importantly, the futures customers we seek to protect.

Proponents of fragmenting futures regulation say it makes no sense having two traffic cops on the same street, but that is exactly the situation that the administration's proposal would create. It would put two federal agencies in charge of regulating one industry.

As a result, the entire futures industry would be subject to wasteful, inconsistent and contradictory regulation by two Federal agencies.

Every aspect of the day to day operations of every Futures Commission merchant, introducing broker, commodity pool operator and commodity trading advisor would inevitably be subject to requirements that could be either contradictory, inconsistent or duplicative.

Segregation of customer funds, the exposure of risks, record-keeping requirements, capital requirements, disclosure documents—in each of these areas and many more, futures professionals would have to serve two masters.

Industry participants would not be the only victims of this barrage of inconsistent and overlapping regulation. Futures self-regulatory organizations, such as NFA, which provide the first line of defense against customer abuses, would also have to cope with delays and inefficiencies inherent in the proposal to split jurisdiction between the CFTC and the SEC.

The bill would affect NFA's operations in a number of ways, none of them good. Reviews of NFA actions to revoke the registrations of unfit persons, rule enforcement review, approval of new customer protection rules, reviews of NFA emergency actions to stop ongoing fraud—in all of these areas and more, NFA would be subject to duplicative and inconsistent regulation.

It is no answer at all to the problems of dual regulation to point out that the New York Stock Exchange and its subsidiary, the New York Futures Exchange, are already subject to regulation by the SEC and the CFTC with no apparent ill effects.

That's not dual regulation at all. It is two different corporations involved in two different businesses under two different sets of legislation and regulations.

The administration's proposal is completely different. It places the 2 cops on the same street, giving 2 Federal agencies overlapping authority to regulate the same futures businesses from exchanges to the 55,000 other futures professionals in different ways.

The effect of these increased regulatory costs on the efficiency and liquidity of U.S. markets is clearly seen by some of those who are closest to the markets—members of the U.S. agricultural community.

That is why agricultural leaders across the country have been unwaivering in their opposition to this proposal, whether they are talking to Secretary Brady or to you, their Senators. No one is more aware of the importance of liquidity in our futures markets than the agri-business men who have been using them for almost 150 years.

They see clearly that this proposal will do great harm to the markets, to the business men that use them, to the consumers who ultimately benefit from them. This fragmented and expensive additional layer of regulation is a quick fix, no thought approach to the very sensitive and delicate problem of market regulation.

If—and I repeat, if—there are any existing problems in the stock market index arena, Congress has ample avenues to effect a broad based approach to any needed reforms without compromising or destroying the solid, workable and effective regulatory structure for futures contracts it put in place 16 years go.

We don't need competing regulators, we need competitive markets. The passage of the administration proposal would, unfortunately, ensure the former, not the latter, causing this economically useful market to flee to foreign shores, where Americans would lose every regulatory advantage that we now have.

Thank you, Senator.

[The complete prepared statement of Robert K. Wilmouth follows:]

SUMMARY OF
TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT
NATIONAL FUTURES ASSOCIATION

BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

My name is Robert K. Wilmouth and I am President of National Futures Association. NFA is the congressionally authorized self-regulatory body for the futures industry. Among all of the self-regulatory organizations in both the securities and futures industries, NFA's position is unique -- NFA operates no marketplace and engages in no commercial activity. NFA exists solely for the purpose of customer protection. I am here today to tell you of NFA's concerns that the proposal to splinter jurisdiction over the futures industry between the CFTC and the SEC could do critical damage to both the futures professionals we regulate and the futures customers we seek to protect.

Proponents of fragmenting futures regulation say that it makes no sense to have two cops directing traffic on the same street, and they are right. The administration's proposal, however, would have exactly that effect. Two cops, the SEC and the CFTC, will both be in charge of regulating the same industry. As a result, the entire futures industry will be subject to the type of contradictory, inconsistent or duplicative regulation that would inevitably result from allowing two cops to regulate one industry. Those 55,000 industry professionals would not be the only victims of the resulting confusion. Futures self-regulatory organizations such as NFA, which provide the first line of defense against customer abuses, would also have to cope with the delays and inefficiencies inherent in the proposal to split jurisdiction between the CFTC and the SEC. When the first line of defense is hamstrung by that sort of bureaucratic maze, the public will invariably suffer.

Just as the "simplicity" of the proposal is a mirage, so are the "compelling problems" it is designed to solve:

- Stock Market Volatility -- There is simply no empirical data linking the futures markets to stock market volatility, and, in fact, every impartial analysis of the issue has concluded that there is no such link.
- Stifling Innovation -- Under CFTC oversight, the U.S. futures markets have been the most innovative financial markets in the world. Index participation contracts could easily have been authorized for trading by the CFTC but the exchanges involved simply chose not to seek such authorization.
- Coordination of Market Regulation -- Self-regulatory organizations in the futures and securities industries have worked together to develop a coordinated system of circuit breakers which is far more extensive than that which exists between SEC-regulated exchanges. Prosecution of intermarket trading abuses has been hindered not by a lack of coordination but by inadequate audit trails at the securities exchanges.

My greatest concern over this proposal, however, is not its effect on the U.S. futures industry, but its effect on U.S. futures customers. Those customers are primarily business people who seek to protect themselves from risks inherent in their industries by transferring those risks to traders who willingly accept them. The ultimate beneficiary of efficient futures markets are the consumers who purchase food, use petroleum products, borrow money, invest in pension funds or engage in any of the basic commercial activities covered by today's futures markets. The ability of businesses to use the futures markets to transfer their risks depends on the liquidity of those markets. The liquidity of those markets can evaporate overnight if regulatory costs become so burdensome that traders have little incentive to participate. The proposed jurisdictional shift could create that environment to the detriment of all.

A thorough and careful review of the regulatory structure of our financial markets is both appropriate and healthy. Unfortunately, the proposal to splinter jurisdiction over futures trading between the CFTC and the SEC is not the product of that type of process. It is a poorly conceived notion and both its rationale and its consequences have not been fully explored. The bill threatens to replace a regulatory structure which has produced the most innovative and most efficient futures markets in the world with a bureaucratic morass of wasteful, inconsistent, and potentially contradictory regulation. The bill will produce none of the benefits it promises and all of the problems it threatens. It is, in short, a bill which richly deserves the staunch opposition of all but those whose empire it will expand.

TESTIMONY OF ROBERT K. WILMOUTH
PRESIDENT
NATIONAL FUTURES ASSOCIATION

BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Chairman Riegle, Distinguished Members of the Committee, Ladies and Gentlemen.

My name is Robert K. Wilmouth and I am President of National Futures Association. NFA is the congressionally authorized self-regulatory body for the futures industry. Among all of the self-regulatory organizations in both the securities and futures industries, NFA's position is unique -- NFA operates no marketplace and engages in no commercial activity. NFA exists solely for the purpose of customer protection. Every dollar in our $28 million budget, which includes not a single cent of taxpayers' money, is spent for that purpose. We carry out this function primarily by adopting and enforcing the highest possible ethical standards for the 55,000 futures commission merchants, introducing brokers, commodity pool operators, commodity trading advisors and associated persons subject to our jurisdiction. I am here today to tell you of NFA's concerns that the proposal to splinter jurisdiction over the futures industry between the CFTC and the SEC could do critical damage to both the futures professionals we regulate and the futures customers we seek to protect.

The debate on whether jurisdiction over futures contracts should be shifted to the SEC has been both heated and, at times, acrimonious. The issues at stake here, however, are of such importance that none of us can allow rhetoric to replace logic in analyzing the administration's proposal. Any rational analysis of that proposal should start with two unassailable premises. First, the current regulatory structure is neither sacrosanct nor immutable. The world we live in is a changeable one and it is both healthy and appropriate to step back periodically and conduct a thorough and thoughtful review of our regulatory structures to see if they are performing their intended purposes. Second, the effective regulation of our financial markets is of such importance that fundamental changes to the regulatory structure should be made only after careful consideration. It is nothing short of reckless to adopt such fundamental changes when neither the rationale nor the consequences of those changes have been carefully considered. "Quick and dirty" solucions to complex issues are generally a lot dirtier than they are quick and seldom solve anything. That is precisely the case with the administration's proposal.

Proponents of fragmenting futures regulation portray their proposal as both a simple and an effective solution to compelling problems in our nation's financial markets. They are wrong on both counts. In fact, the only thing "simple" about this proposal is the reasoning behind it. The genesis of this proposal is the indisputable observation that futures markets are closely linked to the cash markets in the underlying commodity. This is true whether the underlying commodity involves agricultural products, precious metals, foreign currencies, interest rates or stock indices. It is a considerable leap of logic, however, to conclude that because the futures market and cash market of a given commodity are linked they must be regulated by the same regulator. Futures markets serve different purposes, are traded in different ways and have different regulatory needs than the cash markets in the underlying commodities. The logical conclusion of the administration's skewed line of thought is that the wide variety of futures contracts which have been developed since the CFTC's creation would be subject to regulation by a myriad of federal agencies, including the SEC, the Department of Agriculture, the Department of Energy, the Treasury Department and the Federal Reserve Board. In fact, by just about every federal agency except the one with the proven expertise to do the job. The result, of course, would be a nightmarish hodgepodge of inconsistent and contradictory regulatory requirements which no one could comply with. By granting two agencies overlapping authority, the administration's proposal would create the same sort of bureaucratic mess.

I agree wholeheartedly with those who say we cannot have two cops guiding traffic on the same street. Ironically, that is just the situation the administration's proposal would create. Setting two federal agencies loose to come up with different interpretations and regulations involving the same Act would put two traffic cops on the same street, and the futures professionals who travel on that street would come grinding to a halt. Every aspect of the day-today operations of every futures commission merchant, introducing broker, commodity pool operator and commodity trading advisor will be subject to requirements that are either contradictory, inconsistent or duplicative. Segregation of customer funds, disclosure of risks, recordkeeping requirements, capital requirements, disclosure documents -- in each of these areas and many more futures professionals would have to follow the directions of two traffic cops. It is a little unclear just how a businessman is supposed to react when those two traffic cops each give him opposite directions. One thing that is clear, though, is that doubling the federal bureaucracy regulating the futures industry will not double the amount of customer protection, and could have the opposite effect.

Industry participants would not be the only victims of this barrage of inconsistent, wasteful and duplicative regulation. Futures self-regulatory organizations such as NFA, which provide the first line of defense against customer abuses, would also have to cope with the delays and inefficiencies inherent in the proposal to split jurisdiction between the CFTC and the SEC. The bill would affect NFA's operations in a number of ways -- none of them good. NFA actions to deny or revoke the registrations of unfit persons would be subject to review by both agencies which could easily come up with differing interpretations of the fitness standards set forth in the Commodity Exchange Act. Some individuals might be deemed fit by one agency and not by the other. NFA would be caught in the middle of the cross fire and certainly could not operate the sort of stringent and efficient registration screening process which Congress intended when it allowed us to take that job on. NFA already pays for rule enforcement reviews by the Commission and adopts the changes the CFTC recommends. Now we face the prospect of paying twice as much for two reviews giving us inconsistent or contradictory recommendations. We will ultimately be paying more money for less guidance. New customer protection rules could not be implemented until they had been approved by two oversight agencies. Even our disciplinary actions -- including emergency actions to stop ongoing frauds -- could be subject to this sort of duplicative and potentially inconsistent review. When the first line of defense is hamstrung by that sort of bureaucratic maze, the public will invariably suffer.

It is no answer at all to the problems of dual regulation to point out that the New York Stock Exchange and its subsidiary, the New York Futures Exchange, are already subject to regulation by the SEC and the CFTC with no apparent ill affects. That's not dual regulation at all -- it is two different corporations involved in two different businesses under two different sets of legislation and regulations. The administration's proposal is completely different. It places the two cops on the same street, giving two federal agencies overlapping authority to regulate the same futures businesses, from exchanges to the 55,000 other futures professionals, in different ways.

The costs incurred by the entire industry in attempting to comply with two different sets of regulation would be staggering and would be borne, of course, by the customers who use these markets. Two inevitable results would follow. First, the U.S. futures markets would become significantly more costly and less efficient. Second, as regulatory costs in the U.S. increase, futures trading business would flow to foreign markets which offer comparable products at a cheaper price. The technology required to duplicate U.S. futures contracts is basically a Xerox machine. Our foreign competitors have already dramatically reduced our world market share but their real boom period will come when this legislation passes. Those who argue that U.S. markets will not lose business to foreign competitors if margin authority is given to the SEC ignore the fact that trying to comply with the differing interpretations and regulations of two agencies will cause regulatory costs in U.S. markets to soar regardless of what happens to margin levels.

The effect of these increased regulatory costs on the efficiency and liquidity of U.S. markets is clearly seen by some of those who are closest to the markets -- members of the U.S. agricultural community. That is why agricultural leaders across the country have been unwavering in their opposition to this proposal whether they are talking to Secretary Brady or to you, their senators. To suggest, as Senator Eagleton did, that their opposition stems from the Chicago exchanges filling the farmers' heads with a lot of phony arguments takes a pretty condescending view of the farm community and assumes that these issues are just too complicated for the poor farmers to really understand. Nothing could be further from the truth. No one is more aware of the importance of liquidity in our futures markets than the agribusinessmen that have been using them for over 100 years. They see clearly that this proposal will do great harm to the markets, to the businessmen that use them and to the consumers who ultimately benefit from them.

All of these problems are inherent in the concept of splintering jurisdiction over U.S. futures markets between two agencies. The practical problems of this approach are even more apparent when we turn from the general concept to the specific language of the administration's proposal. A review of just three sections of the bill exemplifies the type of disastrous results which this bill could produce -- results its drafters could not have intended and which even its supporters could not desire. For example, Section 4 of the bill attempts to remove the CFTC's exclusive jurisdiction over futures trading and it does so most assuredly. Unfortunately, the bill removes the Commission's exclusive jurisdiction by, in effect, removing all of its jurisdiction over a substantial portion of futures trading. This is roughly the equivalent of curing a headache by cutting off one's head. The bill accomplishes this unlikely result by going far beyond the scope of the Treasury amendment to provide that the Commodity Exchange Act does not apply to and the CFTC has no jurisdiction over exchange-traded and cleared futures contracts on a wide variety of commodities, such as foreign currencies and government securities, unless the exchange chooses to seek formal designation as a contract market. With a sweep of a legislative magic wand, the proposal gives any would-be futures exchange the option of avoiding any federal regulation by simply choosing not to seek CFTC approval for its contracts. Bucket shops will proliferate, fraud will abound, financial stability in our futures markets will be a fond memory and 68 years of federal legislative policy will be undone. Scarcely a desirable or intended effect but clearly the result of the plain language of the bill.

There's further mischief in Section 3(a) of the bill. That section gives the SEC the CFTC's powers under the Commodity Exchange Act with respect to any exchange, futures commission merchant, introducing broker, commodity pool operator and commodity trading advisor doing business in stock index products and with respect to "any futures association whose members include any of the foregoing." That's NFA. Nothing in the bill, however, limits the SEC's authority over NFA to our regulation of the stock index activities of our Members. In fact, a literal reading of the bill would give the SEC complete oversight responsibility for NFA and would oust the CFTC from that role entirely. The SEC would thus have the indirect authority to regulate all aspects of all futures trading subject to NFA jurisdiction. Again, this is hopefully not an intended result but it would be the practical result of the literal language of the bill.

Section 3(e) of the bill also opens the door to the SEC's regulation of the entire industry by granting the SEC exclusive authority to review reparations cases, and thus interpret the Commodity Exchange Act, in all cases involving stock index products. Reparations cases are seldom so neatly compartmentalized to involve only one type of contract. Where the case involves futures contracts for both stock index products and other commodities, the SEC will have exclusive authority to interpret the Commodity Exchange Act as it applies to all issues raised in the case.

Perhaps each of these examples, and there are many more, are mere drafting problems. If so, the drafters can scarcely be blamed. They were working under severe time constraints, dealing with complex issues involving an industry in which they have little experience or expertise. The one point which is clear from all of this -- both the problems inherent in the concept of the bill and the ambiguities of its language -- is that there is nothing simple about this proposal. It is not a mere fine-tuning of the existing regulatory scheme but a radical restructuring of it.

Just as the simplicity of the administration's proposal is a mirage, so are the "compelling problems in our financial markets" that it is designed to cure. The primary justification offered for these dramatic changes to the regulation of our financial markets is that somehow if the SEC has jurisdiction over stock index futures, there would be less volatility in the securities markets themselves. Proponents of the jurisdictional shift treat this supposed link between stock index futures and stock market volatility as an article of faith. Their feeling seems to be that if the proposition is stated often enough, loudly enough and with enough conviction, they can rush through this legislation and bypass the inconvenience of any sort of factual analysis of the proposition. Their reluctance to look at the facts of life in today's complex markets is understandable. The fact is that every single objective analysis of the issue has reached the exactly opposite conclusion -- that there is no demonstrable link between futures trading and stock market volatility. What's truly amazing is not how few facts backers of the jurisdictional shift have to support their position, but how many they had to ignore:

- They had to ignore Alan Greenspan's statement that, "All of the analytical tools we have brought to bear fail to find any relationship between margin levels and volatility."[1]
- They had to ignore the numerous academic studies which have consistently found no basis for the supposed link between stock index futures and stock market volatility.[2]

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[1] Mr. Greenspan's testimony before the Senate Banking Committee on March 29, 1990.

[2] Edward, F., "Does Futures Trading Increase Stock Volatility?" Financial Analysts Journal (January/February 1988): 63-69.

- They had to ignore the fact that those nations which have no stock index futures have experienced significantly more volatility than U.S. markets.

- They had to ignore the candid admission by SEC Commissioner Edward E. Fleischman that, "We really don't understand those markets, it is a different world... You tell me what we [the SEC] would do differently. I would venture to say, nothing."

The notion that whatever ailments there are in the securities markets can be cured simply by further expanding the SEC's jurisdiction and adding a few hundred more employees to its staff may have a superficial appeal but has no basis in fact. Sweeping changes of the kind suggested in this proposal should be backed by something more than wishful thinking.

An integral component of this false premise that futures trading causes stock market volatility is the notion that futures margins are too low. The SEC could supposedly eliminate the volatility by raising margin levels. As I mentioned at the outset of my testimony, NFA operates no marketplace and has no involvement in setting margin levels at the exchanges. I am sure that the exchanges will address this issue in great detail and will expose the flaws in this simplistic reasoning more clearly than I can. But let me make one, common sense point which proponents of this bill seem to be missing: Businessmen do not like to lose money. I have spent my entire adult life in business -- first in banking then in the futures industry -- and have not met one yet who does. When it is the businessman's own money on the line, no federal agency ever created will be as vigilant as the businessman to make sure that those funds are not endangered. That, in a nutshell, is why margin setting authority should stay where it is -- with the exchanges.

The only similarity between margin in the securities industry and the futures industry is the name. Margin in the futures industry does not represent a down payment on the purchase of a security, but a performance bond to ensure that the customer will perform his obligations. If the level of that performance bond is too low to ensure that the customer

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Hardouvelis, G., "Margin Requirements and Stock Market Volatility," Federal Reserve Bank of New York Quarterly Review (Summer 1988).

performs his obligations, his default will have to be covered ultimately by the members of the exchange. In other words, if the exchange members set the margin too low, it is their money that is on the line. That fact may explain why no customer of an exchange member has ever lost a single dollar due to a default. Or why, in sharp contrast to the securities industry, there were no insolvencies among futures brokerage houses as a result of the October 1987 market break. In short, the appropriate level for these performance bonds should be set by the organization which has the most direct interest in keeping them at safe levels, the organization with the clearest understanding of what those safe levels are and the organization which can react most quickly when it is necessary to adjust those levels -- the exchange where the trading is taking place.

Proponents of the administration's position have argued most recently that they are not concerned about the non-existent link between market volatility and futures margin levels but about the effects of exchange actions to raise margin levels during times of market stress. If their feeling is that a federal agency should have the authority to set margins during market emergencies, I agree. But the CFTC already has that authority and there is no compelling reason to move that authority to another agency with less expertise in the futures markets.

Another of the supposedly "compelling problems" this proposal is supposed to cure is that the current regulatory structure has stifled innovation. I will readily admit that stifling innovation is an area where the SEC can profess great expertise. In the last 20 years the only new product introduced on SEC regulated exchanges had been standardized options and the Chicago Board of Trade was the moving force behind that product when it created the Chicago Board Options Exchange. During that same time period no financial market in the world has been more innovative in than the U.S. futures markets. Our markets have introduced, frequently over SEC opposition, successful hedging contracts for government securities, stock index products, foreign currencies, petroleum products, precious metals and agricultural products.

The entire basis for the "stifling innovation" argument is the fact that the two exchanges which recently developed "index participation" futures contracts chose not to seek CFTC authorization to trade them. Although these contracts were really not innovative at all, the Commission had made abundantly clear that it was willing to grant those exchanges expedited consideration and other accommodations, but the exchanges, for business reasons of their own, chose not to do so. As the Solicitor General recently told the Supreme Court, "... allocating jurisdiction over IPs to the CFTC did not doom that product not to be traded." To twist those facts into an argument that the current structure has stifled innovation shows just how little real justification there is for the dramatic regulatory changes that are being suggested.

The third problem that splintering jurisdiction over futures contracts is supposed to solve is a supposed lack of coordination between the SEC, the CFTC and the various self-regulatory organizations in both the futures and securities industries. This line of argument postulates that the various regulatory bodies do not coordinate effectively during times of market stress, that they have not worked together to improve ongoing coordination of regulation or that the present structure hinders the effective prosecution of intermarket trading abuses. The facts, however, suggest otherwise.

In both October 1987 and October 1989, the SEC, the CFTC and the relevant securities and futures exchanges were in constant communication. To my knowledge, no one regulator ever suggested an action which was rejected by another. Each brought to the discussions an intimate knowledge of the intricacies of their own markets which was an invaluable asset in managing the situation. None of the post-mortems studying the market breaks has found any intransigence or lack of cooperation between the various regulatory bodies.

Furthermore, since the October 1987 market turmoil, the self-regulatory bodies from both industries have worked together closely and effectively to create, among other things:

- a five-stage circuit-breaker program negotiated between the Chicago Mercantile Exchange and the New York Stock Exchange that will give the market time to digest important news and help alleviate potentially damaging overreactions;
- a market hotline linking officials at futures, options, and securities exchanges to ensure immediate communications in times of unsettling market activity;
- a clearing organization/clearing bank roundtable that conducts regular meetings to discuss matters of common interest and concern to members;

- an intermarket financial surveillance group, consisting of representatives of all domestic futures and securities exchanges, established to monitor the financial health of clearing members; and
- an intermarket surveillance group created at the direction of the SEC to define trading abuses, devise an effective surveillance system, and assign surveillance responsibility; the futures exchanges that trade equity indices participate in the meetings.

Finally, futures exchanges have been active participants in the intermarket surveillance group and stand ready at all times to share data and other information to identify instances of possible intermarket trading abuses. What is needed to make those efforts more successful is not more cooperation -- there's plenty of that already -- but improvements to the audit trail system in place in the securities industry to provide the same detailed, accurate and immediate trading record that the futures industry produces on a daily basis.

A thorough and careful review of the regulatory structure of our financial markets is both appropriate and healthy. Unfortunately, the proposal to splinter jurisdiction over futures trading between the CFTC and the SEC is not the product of that type of process. It is a poorly conceived notion and both its rationale and its consequences have not been fully explored. The bill threatens to replace a regulatory structure which has produced the most innovative and most efficient futures markets in the world with a bureaucratic morass of wasteful, inconsistent, and potentially contradictory regulation. The bill will produce none of the benefits it promises and all of the problems it threatens. It is, in short, a bill which richly deserves the staunch opposition of all but those whose empire it will expand.

The CHAIRMAN. Thank you, Mr. Wilmouth.

Mr. Seale, let us hear from you now.

STATEMENT OF WILLIAM SEALE, PRESIDENT, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS, WASHINGTON, DC

Mr. SEALE. Thank you, Mr. Chairman. I am Bill Seale, and I appreciate the opportunity to appear today as president of the National Association of Futures Trading Advisors. I am also a full professor of finance in the Business School at George Washington University.

Prior to having these responsibilities, I served as a commissioner of the CFTC from 1983 to 1988. I have twice written each Senator on behalf of NAFTA's nearly 200 members, who collectively manage $6 to 7 billion in futures market funds, to point out our strong opposition to S. 2814.

Regrettably, none of NAFTA's concerns have surfaced during the committee's public discussions of this bill to date, so I am particularly grateful of this opportunity to discuss them with you personally.

Mr. Chairman, the administration bill would impose a second and separate set of Federal regulatory obligations on virtually all of the 2,000 commodity pool operators and commodity trading advisors in business. The cost of overcoming the inconsistencies between Federal commodities and securities laws as they would concurrently apply to these firms would put many of them out of business.

Further, Mr. Chairman, S. 2814 contains several proposed findings, among which are that the same economic forces bear on the equity markets and the stock index futures markets, that they have common participants and that they function as one market.

NAFTA agrees, noting, however, that precisely the same can be said of the relationship between all futures contracts and their related, so-called cash markets.

Indeed, Federal law requires an exchange to prove these very things before the CFTC can approve a new futures contract.

However, I want to point out the findings also contain a glaring mistake, which is that the market trade, quote, "economically equivalent products." That statement is absolutely and unequivocally wrong.

As this committee well knows, the stock market exists to enable buyers and sellers to exchange a finite number of shares representing tangible units of ownership in various corporations.

Futures contracts, however, are bilateral executory contracts representing no tangible interest in anything.

The two markets respond to the same forces. They have to or they won't work. But they do not trade economically equivalent products. Stock index futures contracts and corn futures contracts are economically equivalent products. This is the rationale for functional regulation. This is why the World Bank need not try to regulate foreign currency futures, why the regulation of grain futures was taken away from the Department of Agriculture, why Secretary Brady's Treasury Department would not want to regulate Treasury Bond futures if you gave it to them and why, with all due respect, Chairman Breeden's SEC ought not to try to regulate stock index futures.

Mr. Chairman, NAFTA members are not averse to regulation. Far from it. But, they are averse to being whip-sawed between inconsistent requirements and potential sanctions of two separate Federal requirements and potential sanctions of two separate Federal regulatory agencies.

We are where the term "turf war" ceases to be a catchy phrase. We are the businesses that will be torn in two if S. 2814 passes. In nearly a year's debate on this subject, lots of canards have been offered to justify a bad idea. But, no one has said anything in that time that justifies putting people out of business in order to make room for two Government futures regulators.

In closing, Mr. Chairman, I would like to make a brief comment about futures margins. NAFTA strongly objects to the proposal to subject futures margins to Federal regulation under the SEC or any other Federal agency.

To my knowledge, empirical analysis has never linked the levels of futures margins with price volatility in related cash markets.

As you know, Fed Chairman Greenspan told you just a few months ago that all the analytical resources the Federal Reserve could bring to bear on the question failed to demonstrate any cause and effect relationship between stock index futures margins and volatility in the equities markets.

The Fed controls equity market margins pursuant to a 50-year old authority concerned with the availability of credit in the economy. Futures margins have nothing to do with credit. They are a surety bond which enables clearing houses to assume the opposite side of every futures contract and guaranty performance.

The measure of futures margin effectiveness is that not once in the history of U.S. futures trading has a customer lost money as a result of clearing firm failure.

Senator DIXON. I hope everybody in the committee heard that last few sentences, Mr. Chairman.

Pardon me for interrupting, Mr. Seale.

Mr. SEALE. Quite all right, Senator. [Laughter.]

In sum, Mr. Chairman, we think, since futures margins aren't broken, there's no need to try and fix them.

[The complete prepared statement of William E. Seale follows:]

Statement of William E. Seale, Ph.D.
President, National Association of
Futures Trading Advisors
before the
United States Senate
Committee on Banking, Housing, and Urban Affairs
July 24, 1990

Mr. Chairman, I am Bill Seale, and I appreciate the opportunity to appear today as President of the National Association of Futures Trading Advisors. I am also a Full Professor in the Finance Department of the School of Business and Public Management at The George Washington University. Prior to having these responsibilities, I served as a Commissioner of the CFTC from 1983 to 1988.

I have twice written each Senator on behalf of NAFTA's nearly 200 members, who collectively manage $6 - $7 billion in futures market funds, to point out our strong opposition to S. 2814. Regrettably, none of NAFTA's concerns have surfaced during the Committee's public discussions of this bill to date, so I am particularly grateful for this opportunity to discuss them with you personally.

Mr. Chairman, the Administration bill would impose a second and separate set of federal regulatory obligations on virtually all of the 2,000 Commodity Pool Operators (CPO's) and Commodity Trading Advisors (CTA's) in business. The cost of overcoming the inconsistencies between federal commodities and securities laws, as they would concurrently apply to these firms, would put many of them out of business.

Furthermore, the burdens of these inconsistencies would stand as formidable barriers to entry into professional futures money management. As the financial markets grow in their complexity, investors should have the benefit of more, not fewer competitors in the professional money management field.

The Administration bill would have the SEC regulate CPO's and CTA's with respect to their trading or advice as it involves stock index futures. The CFTC would regulate them with respect to all other futures market activity, including futures trading in numerous United States Treasury securities, Eurodollar certificates of deposit, and soon, reinsurance risk. Thus, not only would this transfer of an arbitrary slice of regulatory responsibility create unbearable costs to hundreds of small businesses -- it makes absolutely no sense from either economic or public policy standpoints.

S. 2814 contains several proposed findings:

- the same economic forces bear on the equity markets and the stock index futures markets;
- they have common participants; and
- they function "as one market."

NAFTA agrees, noting, however, that precisely the same can be said of the relationship between all futures contracts and their related so-called cash markets. Indeed, federal law requires an exchange to prove these very things before the CFTC can approve a new futures contract.

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variation margin, that either they must pay or will be paid to them.

In the next few hours, those payments will be made over the Federal Reserve Wire System.

Later this morning, my staff will again be contacted by the exchanges and told how much money we will be required to put up in anticipation of the next day's variation margin call based upon today's price movement.

These transactions are completed by the close of the Federal Reserve Wire at 3 p.m. In other words, we settle with the exchanges twice a day on a cash on the barrel head basis.

Come November with the start of Globex, we will actually have to settle three times a day.

In addition to variation margin, I am required to collect from my customers a minimum initial margin or risk margin as a good faith deposit to guarantee that they will meet their daily variation payments.

It is this margin that appears to be the focus of the current heated debate. In a business in which gains and losses are settled once, twice or three times a day, the purpose of the initial margin is to protect me if my customers are late for 1 or 2 days in meeting their variation payments.

This is not my only protection, of course. I reserve the right to protect myself futher by liquidating their positions if their variation payments are not forthcoming.

I also reserve the right to collect initial margins that are higher than those required by the exchanges if I have reason to be concerned about the credit of any one customer.

Quite frankly, this margin system is the strength of the futures industry. There is no financial market with a more stringent set of financial requirements.

The stock market, for example, settles every 5 business days, 7 calendar days, even on margin transactions.

The currency market and the Government securities market settle every day, as does the bank market. None of these markets settles more than once a day.

These procedures have been designed by representatives from the world's major financial institutions and have resulted in a record of zero cutomer losses through exchange default.

Off exchange markets, on the other hand, have suffered a string of losses due to counterparty default. Most of these involve forward markets where the magnitude of problems was permitted to grow to large proportions.

In the futures market, we detect problems early because we collect money immediately. As a result, problems are contained.

The SEC does not seem to appreciate the soundness of this system. The most recent evidence of this was the surprising suggestion that I and other members of my industry should lower margin demands in times of stress.

Neither my shareholders, customers nor employees would think this an appropriate action to take. My job is to protect the interests of my shareholders.

It seems to me that the SEC has confused private roles with public policy need for our central bank, the Federal Reserve to be

However, I want to point out the findings also contain a glaring mistake: that the markets trade "economically equivalent products." That statement is absolutely and unequivocally wrong. As this Committee well knows, the stock market exists to enable buyers and sellers to exchange a finite number of shares representing tangible units of ownership in various corporations. Futures contracts, however, are bilateral executory contracts representing no tangible interest in anything. Buyers and sellers exchange only contractual obligations to do something in the future; and one extinguishes those obligations not by selling what he bought or vice versa, but by entering into opposite and offsetting contracts. Further, because they are ultimately settled in cash, one could not buy or sell a security, or a group of them, in the stock index futures market if his life depended on it. The two markets respond to the same forces -- they have to or they won't work -- but they do not trade "economically equivalent products."

Stock index futures contracts and corn futures contracts are economically equivalent products. This is the rationale for functional regulation. This is why the World Bank need not try to regulate foreign currency futures; why the regulation of grain futures was taken away from the Department of Agriculture; why Secretary Brady's Treasury Department would not want to regulate Treasury Bond futures if you gave it to them; and why, with all due respect, Chairman Breeden's SEC ought not try to regulate stock index futures.

Identical trading practices, identical market surveillance techniques, identical risk disclosure needs, identical brokerage operations, and a myriad of other similarities accompany all futures trading. Thus, effective regulation of all futures markets requires rigorous application of consistent rules.

The likely costs of inconsistent rules and dual regulation under S. 2814 would be unique, substantial, and uniformly harmful for exchanges, floor brokers, futures commission merchants, and commodity pool operators and commodity trading advisors. However, I would like to address only their impact on the commodity pool operators and commodity trading advisors which make up NAFTA's membership.

The SEC regulates the activities of investment companies and investment advisors -- roughly the securities industry equivalents of CPO's and CTA's. Why couldn't CPO's fall under the Investment Company Act with respect to stock index futures activity in their portfolios?

1. The Investment Company Act has different requirements for composition of boards of directors, and for use of brokerage firms, than the Commodity Exchange Act, which would prohibit most CPO's from operating;
2. The Investment Company Act calls for SEC rules to prohibit short sales and purchases on margin by investment companies -- and such rules would completely outlaw all futures trading;

3. The Investment Company Act establishes a statutory net worth requirement inconsistent with the Commodity Exchange Act, and sets specific requirements for qualifications and hiring of certified public accountants by investment companies -- an extremely expensive overlapping burden for small businesses such as most CPO's;
4. The Investment Company Act regulations specify detailed financial recordkeeping and reporting requirements completely different than CFTC requirements -- requiring maintenance of double sets of books and records and exposure to sanctions for failure to meet either set of requirements;
5. The Investment Company Act establishes specific requirements for contracts between investment companies and investment advisors -- which would require CPO's to renegotiate all existing arrangements with CTA's, at least with respect to trading advice concerning stock index futures.

Why couldn't the SEC regulate stock index futures activities of commodity trading advisors under the Investment Advisers Act?

1. The Investment Advisers Act outlaws compensation based on a share of capital gains or capital appreciation -- a compensation method authorized and regulated under the Commodity Exchange Act, and utilized by virtually every CTA in business;
2. SEC regulations under the Investment Advisers Act mandate the disclosure of investment performance by reference to an independent index and pursuant to a formula described over three full pages of the Code of Federal Regulations -- and the CFTC's requirements, while no less complex, are calculated differently and are referenced to a completely different standard.

   This difference alone, requiring maintenance of two completely different sets of historical data and the application of two completely different computer programs, would result in the disclosure to customers of utterly worthless information at twice the cost of the present regulatory scheme.

NAFTA members are not averse to regulation. Far from it. But they are averse to being whipsawed between the inconsistent requirements and potential sanctions of two separate federal regulatory agencies. We are where the term "turf war" ceases to be a catchy phrase -- we are the businesses that will be torn in two if S. 2814 passes.

In nearly a year's debate on this subject, lots of canards have been offered to justify a bad idea. But no one has said anything in that time that justifies putting people out of business in order to make room for two government futures regulators.

Mr. Chairman, this matter is of grave concern to the professional futures money management industry of this country. I appreciate the opportunity to discuss the reasons for our concerns, and I would be pleased to answer any questions.

The **Chairman**. Thank you, Mr. Seale.

Mr. Petersen, we would be pleased to hear from you now.

STATEMENT OF ROBERT R. PETERSEN, PRESIDENT, NATIONAL GRAIN TRADE COUNCIL, WASHINGTON, DC

Mr. **Petersen**. Thank you, Mr. Chairman, members of the committee. It's a pleasure to appear before you today to share the National Grain Trade Council's concerns with S. 2814. I am Bob Petersen, president of the National Grain Trade Council.

The council is vitally interested in pending legislation to reauthorize the Commodity Futures Trading Commission, S. 1729.

Senate action on the CFTC bill has been delayed, however, over efforts to shift the regulation of stock index futures to the SEC.

The National Grain Trade Council has joined 23 other agricultural groups to oppose these efforts. We have written to Members of the Senate on at least two occasions to express our concerns over proposals that would split off portions of the CFTC's authority.

Mr. Chairman, I have with me copies of those two letters and I would ask that they be made a part of the hearing record today.

Agriculture's view is clear, Mr. Chairman. The Treasury-SEC bill is bad for agriculture and we believe bad for America.

Agriculture believes the bill would, one, weaken the CFTC at a time when the agency should be strengthened.

Two, would create regulatory chaos for futures exchanges and industry professionals who would be regulated by two different agencies with different, and often conflicting sets of rules.

Three, could endanger commercial market liquidity by requiring Federal regulators to set margins.

And, four, demonstrates a profound lack of knowledge of the sensitive nature and operation of futures markets.

While I am not here today to testify for any of the other agricultural groups, the National Grain Trade Council has parallel views on these issues.

S. 2814 would split off the CFTC's jurisdiction over stock index futures and give this authority to the SEC. We wish to point out that the CFTC regulates exchanges, not just contracts.

Agricultural and financial futures are traded on the same trading floor subject to the same rules, by the same people.

Dual agency jurisdiction over futures exchanges under two different and conflicting sets or rules is a prescription for regulatory disaster.

S. 2814 would grant the SEC oversight authority over stock index futures margins. We believe exchanges are better suited to establishing appropriate margin levels in response to changing market conditions. They have a direct self-interest in balancing the twin needs of market efficiency and protection of the financial integrity of the market.

S. 2814 would modify the exclusivity provisions of the Commodity Exchange Act in such a clumsy fashion as to potentially deregulate agricultural and financial futures trading.

Furthermore, Mr. Chairman, it is unclear how the administration's bill would prevent or mitigate the next stock market decline.

Markets go up and markets down based on economic fundamentals. That is their nature.

Market adjustments do occur in a shorter timeframe today than 20 years ago. But, as the Federal Reserve has stated, and I would like to quote:

> The volatility we observe reflects more basic changes in economic and financial processes prompted by technological advances and the increasing concentration of assets in institutional portfolios.

The Federal Reserve has also said, and I quote again:

> The Board does not believe that the existing division of regulatory authority has increased volatility in the securities market nor in this regard is it a threat to the capital formation process.

In addition, Fed Chairman Alan Greenspan testified before this committee in March, stating as follows:

> I think that if there is a major market reaction, it is likely to occur with or without changes that we're talking about. And I'm not certain the extent to which the types of changes we're talking about would make all that much substantial difference in how the particular break worked its way through the system.

The fundamental premise behind the administration's bill is that the stock options and stock index futures markets constitute one market. That should not come as a revelation.

Agricultural cash and futures markets have formed one market for over 100 years. The one market theory we believe restates the obvious, and it is not justification for one regulator.

The administration's concept, if carried to its logical conclusion, would have the regulator of every cash market also regulate the futures market.

The one market theory should not be misused to make stock index futures the scapegoat for economic fundamentals in the stock market or any other markets.

In conclusion, Mr. Chairman, no one has made a compelling case that this Nation would be better served if S. 2814 were enacted. The National Grain Trade Council urges that this committee oppose the measure and support prompt enactment of S. 1729, legislation to reauthorize the CFTC.

And if I might also, in closing, just remark on one item which Senator Heinz mentioned earlier. And that is that debate over S. 2814 is being widely perceived as a debate between Wall Street and Lasalle Street. I would take it one step further—I think it's a debate or an argument between Wall Street and Main Street.

Thank you.

[The complete prepared statement of Robert R. Petersen follows:]

Statement of

Robert R. Petersen
President
National Grain Trade Council

before the

Committee on Banking, Housing and Urban Affairs
United States Senate

on

S. 2814
"Capital Markets Competition, Stability, and Fairness Act of 1990"

July 24, 1990

Mr. Chairman and Members of the Committee:

It is a pleasure to have the opportunity to appear before you today to share the National Grain Trade Council's concerns over S. 2814, the "Capital Markets Competition, Stability, and Fairness Act of 1990." I am Robert R. Petersen, president of the National Grain Trade Council.

The Council is a national trade association whose members cover the full spectrum of the agribusiness infrastructure. The Council's regular members include grain exchanges, both cash and futures, and its associate members include grain companies and related businesses. Our members include firms who handle bulk grains, transportation firms, companies that process agricultural products into consumer-ready items we purchase on the grocery shelf, cash markets where grain is bought and sold, and futures markets where the price risks associated with all of these grain merchandising activities are hedged. In terms of the issue before the Committee today, you might say the Council's membership encompasses "one market," cash and futures grain market participants.

Futures markets and the grain trade grew up side-by-side in the United States economy. Since the middle of the last century, the grain industry has relied on futures markets to hedge market risks; and futures markets have fulfilled that purpose in an open and efficient manner. American consumers are thus deep into their second century of enjoying the wide-ranging benefits of price efficiency created by this economic relationship.

The Council is vitally interested in the pending legislation to reauthorize the Commodity Futures Trading Commission, S. 1729 and related issues. Senate action on this important legislation has been delayed over concerns that stock index futures exacerbated the stock market downturns that occurred in October 1987 and October 1989.

This concern has led the Treasury Department to propose S. 2814, the bill that is before the Committee today. This measure is intended to accomplish three objectives:

1. transfer authority to regulate stock index futures from the CFTC to the Securities and Exchange Commission;

2. grant the SEC oversight authority over the ability of futures exchanges to set stock index futures margins; and

3. modify the "exclusivity clause" of the Commodity Exchange Act to permit new financial instruments with elements of futures to trade without CFTC regulation.

The National Grain Trade Council opposes the Administration's bill. Among other reasons, we fail to see how the bill would prevent or mitigate the next stock market decline.

The Council has joined other agricultural groups to vigorously oppose the Administration's bill. Agricultural groups have written to Members of the Senate on two occasions to express our concerns over proposals to split off portions of the CFTC's authority.

Mr. Chairman, I have attached these two letters to my statement and I ask that they be made part of the hearing record. The first letter is dated March 27, 1990 and is signed by 18 national agricultural groups; the second letter is dated July 10 and is signed by 24 agricultural groups. I have heard many people remark about how unusual it is to see these diverse groups agree on any one single issue. But that is the case regarding our views on CFTC jurisdiction. The groups co-signing these letters range from the National Farmers Union to the American Farm Bureau Federation; the National Cotton Council to the National Cattlemen's Association.

Agriculture's view is clear: the Treasury/SEC bill is bad for agriculture and, therefore, we believe, bad for America.

As we explained in our July 10 letter, agriculture believes the bill before this Committee today:

1. would weaken the CFTC at a time when the agency should be strengthened;
2. would create regulatory chaos for futures exchanges and industry professionals who would be regulated by two different agencies with different and often conflicting sets of rules;
3. could endanger commercial market liquidity by requiring federal regulators to set margins; and
4. demonstrates a profound lack of knowledge of the sensitive nature and operation of futures markets.

While I am not here today to testify for any of the other agricultural groups, the National Grain Trade Council has parallel views on the issue.

The Treasury/SEC proposal confirms our earlier fears.

1. S. 2814 would split off the CFTC's jurisdiction over stock index futures and give this authority to the SEC. We wish to point out that the CFTC regulates exchanges, not just contracts. Agricultural and financial futures are traded on the same trading floors, subject to the same rules, by the same people. Dual agency jurisdiction over futures exchanges, under two different and conflicting sets of rules, is a prescription for regulatory chaos.

   In practice, granting the SEC jurisdiction under the Commodity Exchange Act to regulate stock index futures would mean that both the SEC and the CFTC (under different statutory standards) would have to approve new registrants. This would affect contract markets, futures commission merchants and their associated persons, floor brokers, introducing brokers and their associated persons, commodity pool operators and their associated persons, commodity trading advisors and their associated persons, and floor traders.

In addition: (1) both the SEC and the CFTC will have to approve exchange rule changes; (2) both agencies will have to decide appeals from exchange disciplinary actions; (3) exchanges and brokerage firms will be subject to two different trade practice and market surveillance oversight systems, and different financial and auditing standards; and (4) exchange members and large traders could be required to file position and other reports with both agencies under two different reporting systems.

This clearly sets the stage for duplicative or conflicting CFTC and SEC action under the Commodity Exchange Act. Furthermore, industry professionals and exchanges will have to bear the cost of complying with these duplicative regulatory schemes. It is reasonable to assume this will require exchanges and firms to employ additional personnel to insure compliance with the regulations of both agencies. As we look at it, piling costs on industry participants is hardly designed to increase U.S. financial competitiveness.

2. S. 2814 would grant the SEC oversight authority over stock index futures margins. This recommendation ignores the fundamental difference in margins between securities and futures. Stock margins are a downpayment on a cash purchase, like buying a car, which only the buyer pays. Futures margins, which are received from both the buyer and seller, serve as performance bonds to ensure the financial integrity of the futures markets.

In futures markets, the exchange clearinghouse is the opposite party to every buyer and seller. The clearinghouse independently guarantees the performance of the futures contract to each party. Initial futures margins are earnest money payments required from both sides of the transaction by the clearing system. This initial margin provides the system a cushion to absorb losses if the buyer or seller fails to make additional payments, known as the variation margin, when the price moves against the market participant.

The SEC has criticized the level of stock index futures margins as being too low. However, not a single clearing member of a futures exchange failed to fulfill its obligations during the market drops of October 1987 and October 1989. In other words, the earnest money cushion has never failed to be sufficient.

Nevertheless, the Chairman of the SEC has said his agency, if granted margin oversight authority, would increase stock index margins. But there is no basis for such a step. Even the Federal Reserve Board has said it cannot find any evidence that margin levels affect volatility. Thus, this proposal raises a particularly troubling precedent for agricultural futures. If this philosophy of setting margins at higher than prudential levels were applied to agricultural futures, it would increase the cost of business for market participants, reduce market liquidity, and thereby reduce the usefulness of the markets for hedging and as a price discovery mechanism.

Futures margin authority should remain with exchanges. Exchanges are better suited to establishing appropriate margin levels in response to changing market conditions. Exchanges have a direct self-interest in achieving an appropriate balance between the twin needs of market efficiency and protection of the financial integrity of the market.

3. S. 2814 would modify the "exclusivity" provision of the Commodity Exchange Act in such a clumsy fashion as to potentially permit a futures exchange to withdraw its contract market designation for agricultural and financial futures and continue to trade the contracts without Federal oversight. It is doubtful this result was intended by the Treasury/SEC authors, but illustrates the inexperience of those agencies in the regulation of futures.

The Treasury/SEC amendment could take risk shifting activity in agricultural commodities completely out from under any federal oversight. Thus, the measure confirms our earlier fears and could return futures regulation to the 19th century.

Furthermore, the National Grain Trade Council fails to see how the Administration's bill would prevent or mitigate the next stock market decline. Markets are cyclical and are driven by underlying economic fundamentals. Markets go up and markets go down, that is their nature. Market adjustments do occur in a shorter time frame than was the case 20 years ago. But, as the Federal Reserve has stated ". . . the volatility we observe reflects more basic changes in economic and financial processes prompted by technological advances and the increasing concentration of assets in institutional portfolios."

The Federal Reserve has also said " . . . the Board does not believe that the existing division of regulatory authority has increased volatility in the securities markets, nor in this regard is it a threat to the capital formation process."

In addition, Fed Chairman Alan Greenspan testified before this Committee on March 29, 1990 stating:

> I think that if there is a major market reaction, it is likely to occur with or without changes that we're talking about and I'm not certain the extent to which the types of changes we're talking about would make all that much substantial difference in how the particular market break worked its way through the system.

The fundamental premise behind the Administration's bill is the discovery that the stock, stock options, and stock index futures constitute one market. That should not come as a revelation. Each cash market and its related futures market form "one market."

For example, agricultural cash and futures markets have formed one market for over 100 years. Earlier this century, cash grain market participants expressed concern about volatility in the futures market and sought to control futures. In the intervening years, agriculture has come to grips with the fact that cash and futures form one market. Futures markets allow users to shift price risks associated with the cash commodity. Futures reflect cash market attitudes and values. There is no reason to believe the economic issues are different for stocks and their derivative markets.

Supporters of S. 2814 have strongly implied that a change in regulatory jurisdiction for stock index futures would mitigate against the chances of another stock market decline. That is simply not the case; this bill does nothing to remove the possibility of another market "correction." To imply otherwise is to imply a degree of safety that is impossible to deliver. It only raises false hope among investors.

Nowhere do the various multi-agency studies of the recent stock market breaks conclude that stock index futures were a root cause of the market declines. Nothing indicates stock index futures drive the cash market. Futures markets reflect the opinions of a diverse universe of market users about the future value of the underlying cash instrument.

The one market theory, therefore, restates the obvious and certainly is not sufficient justification for one regulator. The concept behind the Administration's proposal, if carried to its logical conclusion, would have the regulator of the cash market also regulate the futures market. In other words, the Department of Energy would regulate petroleum futures, the Treasury Department would regulate Treasury bond and currency futures, the Department of Agriculture would again regulate agricultural futures, and perhaps the Department of Housing and Urban Development would regulate GNMA futures. The one market theory, therefore, should not be misunderstood and permit stock index futures to be made the scapegoat for economic fundamentals in the stock market or any other markets.

In conclusion, Mr. Chairman, no one has made a compelling case that this nation would be better served if S. 2814 were enacted. The National Grain Trade Council urges that this Committee oppose the measure and support prompt enactment of S. 1729, legislation to reauthorize the CFTC.

With time running out for this session of Congress, it now appears problematic whether the CFTC reauthorization bill can be approved by the Senate prior to adjournment. Whether that measure becomes law this session largely rests in the hands of the Members of this Committee. We strongly urge that S. 1729 be allowed to move forward expeditiously.

The Council appreciates the opportunity to share our views with you today on these very important issues.

March 27, 1990

Dear Senator Dodd:

As representatives of all segments of U.S. agriculture, we are writing to express our deep concern with the jurisdictional dispute between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). In recent weeks, some have asserted that the SEC, not the CFTC, should have jurisdiction over some financial futures contracts, most notably stock index futures. We believe this could ultimately jeopardize agricultural futures.

Why are we as agricultural groups worried about stock index futures? Because the CFTC regulates exchanges, not just contracts. Agricultural and financial futures are traded on the same trading floors, subject to the same rules, by the same people. Dual agency jurisdiction over futures exchanges, under two different laws, would be a prescription for regulatory chaos.

We support a strong, independent CFTC with exclusive jurisdiction over futures contracts. A strong CFTC would be strengthened even more under the Senate's pending reauthorization legislation.

We vigorously oppose weakening the CFTC by splitting-off some of its jurisdiction. We are equally opposed to the idea of making the CFTC a division of the SEC. Such a combination would be unworkable because the SEC has no experience in agricultural futures or their regulation. The SEC would undoubtedly seek to superimpose its view of stock market regulation on futures markets. Although futures markets have a 140-year tradition of providing efficient price discovery and hedging mechanisms, these are roles and functions that are fundamentally different from the markets the SEC now oversees. For example, a recent NEW YORK TIMES article quotes SEC Commissioner Edward Fleischman as saying, "We really don't understand those markets, it is a different world. You tell me what we would do differently. I would venture to say nothing."

The efficient, fair pricing of agricultural products would inevitably suffer under a change in jurisdictional authority. We should not leave the impression we always agree with the CFTC, but we value the expertise developed under current oversight authority during nearly 70 years of futures market regulation. For these reasons, we strongly urge Congress to maintain an independent CFTC.

Sincerely,

American Cotton Shippers Association
American Farm Bureau Federation
American Oat Association
American Soybean Association
Millers' National Federation
National Association of Wheat Growers
National Cattlemen's Association
National Corn Growers Association
National Cotton Council
National Council of Farmer Cooperatives
National Farmers Organization
National Farmers Union
National Grain and Feed Association
National Grain Sorghum Producers Assoc.
National Grain Trade Council
National Grange
National Pork Producers Council
North American Export Grain Assoc.

(Identical letters were sent to all members of the Senate Committees on Banking and Agriculture and to all members of the House Committees on Energy and Commerce and Agriculture.)

July 10, 1990

Dear Senator Riegle:

We the undersigned, representing a broad spectrum of American agriculture, urge the Senate to promptly pass S. 1729, a bill reauthorizing the Commodity Futures Trading Commission (CFTC). We also reiterate our strong opposition to any proposals that would weaken the CFTC. Specifically, we urge you to oppose an Administration amendment which would among other things, transfer jurisdiction over stock index futures from the CFTC to the SEC.

We believe the amendment (1) would weaken the CFTC at a time the agency should be strengthened; (2) would create regulatory chaos for futures exchanges and industry professionals who would be regulated by two different agencies with different and often conflicting sets of rules; (3) could endanger commercial market liquidity by requiring federal regulators to set margins; and (4) demonstrates a profound lack of knowledge of the sensitive nature and operation of futures markets.

Treasury Secretary Nicholas Brady met with agricultural groups on June 28, and asked us to step aside on the Treasury/SEC proposal. Mr. Brady, ironically, argued that agriculture would benefit by the proposal because it would allow the CFTC to focus its efforts on agricultural markets. We, the undersigned reject that argument.

We write once again to make our position crystal clear: the Treasury/SEC amendment is bad for agriculture and accordingly, bad for America. Agriculture supports a strong, independent CFTC as a policeman of the nation's futures markets -- a CFTC with more, not less, resources to oversee all futures markets. S. 1729 would accomplish that goal.

The Treasury/SEC proposal would directly affect agricultural interests. Forcing futures exchanges, firms, and other market professionals to follow two different sets of rules, the proposal would dramatically increase the cost of doing business. Those who benefit most from America's futures markets, consumers, will ultimately bear those costs.

The jurisdiction issue is not a battle between Wall Street and LaSalle Street, it is an attack by Wall Street on Main Street. Therefore, we urge you to consider our concerns and to support a strong, independent CFTC as the exclusive regulator of the nation's futures markets.

Sincerely,

American Agri-Women
American Cotton Shippers Association
American Farm Bureau Federation
American Feed Industry Association
American Meat Institute
American Oat Association
American Soybean Association
Millers' National Federation
National Association of Wheat Growers
National Cattlemen's Association
National Corn Growers Association
National Council of Farmer Cooperatives
National Cotton Council
National Farmers Organization
National Farmers Union
National Grain and Feed Association
National Grain Trade Council
National Grain Sorghum Producers Assoc.
National Grange
National Pork Producers Council
National Turkey Federation
North American Export Grain Association
Rice Millers' Association
U.S. Beet Sugar Association

(Identical letters sent to all Senate members.)

Senator DIXON. Mr. Chairman, I ask that the two letters Mr. Petersen referred to be admitted in the record. Those are two letters representing the view of every major agricultural group in America, expressed against this bill.

The first letter, Mr. Chairman, distributed to everybody in the Congress; thereafter, the Treasury and other administration people called in all these groups and consulted with them. After that consultation, these groups, again, unanimously signed a similar letter expressing their continued view against this legislation.

Senator DODD [presiding]. Without objection, the two letters will be included in the record.

Mr. Lane.

STATEMENT OF MORTON LANE, PRESIDENT, DISCOUNT CORPORATION OF NEW YORK FUTURES, CHICAGO, IL

Mr. LANE. Mr. Chairman, distinguished members of the committee, my name is Morton Lane and it is in my capacity as president of Discount Corporation of New York Futures, a financial futures brokering company, that I address you this morning.

Since 1979, Discount Futures has served major international institutions in brokering financial futures. Our business comprises interest rates and foreign currency futures and, to a lesser degree, stock index futures.

The bill that you are considering today would represent a considerable threat to my business, and I believe, the industry as a whole.

Perhaps the thread that runs through all of my comments is: Why is this bill necessary?

From my part, I see no problem that requires such a huge legislative effort.

Jurisdiction. At the present time, I am regulated by the CFTC. It happens that my firm is also a registered securities broker-dealer for nonfutures products.

The proposed legislation appears to suggest that we could well be regulated by two regulators for the same futures products after the bill is passed.

This, it seems, is cumbersome and unnecessary. I do not care what the name of the entity that regulates my business is. What I do care about is that the designated regulator be a knowledgeable one, familiar both with my industry and its practices.

The CFTC, I believe, has demonstrated over the past 15 years that it is knowledgeable. The SEC, on the other hand, especially in its recent rhetoric, seems to have demonstrated just the opposite, that it does not understand the futures business.

Nowhere is this more apparent than in the area of margins. It seems to me that not everybody understands how futures are margined. This morning, between 4 a.m. and 9 a.m., my staff in Chicago paid or received cash that was due to or from the exchanges upon which we are clearing members. These payments or receipts were calculated on the basis of yesterday's gains and losses, not those of last week.

At the same time, we have contacted each of our institutional accounts and informed them of the amounts of money, which we call the lender of last resort, a role that it discharged admirably in the last two market breaks.

Off exchange trading. The removal of the CFTC exclusivity clause as characterized in this bill will, I believe, promote the movement of futures trading off exchange. This is regrettable and will reduce competition rather than promote it.

I am not against competition. I believe in competition within structures that are sound and I believe that the existing futures structure is both sound and competitive.

Indeed, the futures industry is already very competitive. It has certain characteristics which economists use to describe perfect competition. There are no barriers to entry. For example, each of the stock exchanges has its own futures subsidiary.

There are a large number of players and rates of return are low. The proposed modification of the exclusivity clause could well gut the futures exchanges. The proposed modification I think has overshot the mark.

At the same time, I believe the CFTC has on occasion set up criteria to exempt itself from jurisdiction over hybrids, such as swaps. This is healthy, as was the outcome of the Shad-Johnson accord.

I would favor a mechanism that would allow such compromises, but this proposed modification to the CEA is not it.

Thank you.

[The complete prepared statement of Morton Lane follows:]

SUMMARY OF TESTIMONY

Morton Lane
President, Discount Corporation of New York Futures

Before the

UNITED STATES SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

July 24, 1990

My name is Morton Lane, and I am here in my capacity as President of Discount Corporation of New York Futures, a futures broking company. In this capacity, I am representing my interests as a business man in the futures industry.

I would like to comment on three areas dealt with by the proposed legislation. These are

- Jurisdiction
- Margin Supervision
- Off-Exchange Futures Activity

Jurisdiction

Like any business man, if I am to be regulated, I would rather be regulated by a single entity that is knowledgeable about my industry and its practices. Over the past 15 years, the CFTC has proven itself to be just such a knowledgeable regulator.

The SEC, on the other hand, especially in its recent rhetoric, seems to have demonstrated just the opposite; that it does not understand the futures business.

Nowhere is this more apparent than in the area of margins.

Margins

People, for the most part, fail to appreciate the stringent financial practices that govern the futures business. Our margining system is as prudent as one could devise while still allowing business to carry on.

What sets us apart from the stock market and off-exchange markets for government securities, foreign currencies, and swaps, is that we are a "cash on the barrel head" business.

The part of the financial formula in the futures business that goes unnoticed in the public debate over margins is that we require participants to make good on the gains and losses immediately. Yesterday's losses are paid for, in cash, over the Federal Reserve's wire system, no later than today. In some instances, yesterday's losses were paid for yesterday.

In contrast, the stock market allows five business days, which is seven calendar days, for settling stock transactions, even margined transactions. And no market outside of futures settles gains and losses intraday.

Quite frankly, our margining system is the strength of the futures industry, which has avoided the kind of embarrassing financial episodes that have plagued the off-exchange markets. Moreover, it has set standards for these other markets, both here and abroad.

Off-Exchange Futures Activity

Here, I am told that the intent of the proposed legislation is to foster competition. On this score, I believe in competition within structures that are sound. I also believe that the existing futures exchange structure is both sound and competitive.

There are no barriers to entry. The number of players is large. The playing field could not be more level. And the rates of return are low.

The proposed legislation would threaten to move futures trading to off-exchange markets and would deny access to all but those with large amounts of capital. Thus, I believe that competition could well be hindered by the proposed amendment to the CEA.

Conclusion

Let me conclude by noting that to the extent that in the future new products raise questions of proper jurisdiction, I believe these questions can be hammered out by the two agencies. Indeed, they have demonstrated a capacity to do so as they did in the compromise struck by the Shad/Johnson Accord. The proposed modification to the CEA is not the way to go.

STATEMENT
OF
MORTON LANE,
PRESIDENT, DISCOUNT CORPORATION OF NEW YORK FUTURES

BEFORE THE
UNITED STATES SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS

July 24, 1990

Chairman Dodd, and distinguished members of the Committee:

My name is Morton Lane, and I appreciate the chance to address you this morning. I am a member of the Chicago Board of Trade, the Chicago Mercantile Exchange, and a Director of the Futures Industry Association.

It is in my capacity as President of Discount Corporation of New York Futures, a financial futures broking company, that I address you this morning. Discount Futures, as we are known informally, is a wholly owned subsidiary of Discount Corporation of New York, a primary dealer in U.S. government securities since 1919. We are members of the world's principal futures exchanges, and we have offices in Chicago, New York, Philadelphia, London, Singapore, Tokyo, and Hong Kong.

Since 1979, Discount Futures has served major international institutions in broking financial futures.

Our business comprises interest-rate and foreign currency futures, and to a lesser degree, stock index futures. We do not do retail business. Nor do we clear the accounts of local traders. Our sole source of revenue is commission income. We are a part of the financial futures industry, and our growth has tracked that of the industry, both domestically and internationally.

The bill that you are considering today, "Capital Markets Competition, Stability, and Fairness Act of 1990," would represent a considerable threat to my business and, I believe, the industry as a whole. There are three areas on which I would like to comment:

- Jurisdiction
- Margin Supervision
- Off-Exchange Futures Activity

Perhaps the thread that runs through all of these comments is "why is this bill necessary?" For my part, I see no problem that requires such a huge legislative effort.

Jurisdiction

At the present time, I am regulated by the CFTC. It happens that my firm is also a registered securities broker dealer with the SEC, but for non-futures products. The proposed legislation appears to suggest that we could well be regulated by two regulators for the same product. This, it seems, is cumbersome and unnecessary.

Like any business man, if I am to be regulated, I would rather be regulated by a single entity. Frankly, I do not care what the name of that entity is. What I do care about is that the designated regulator be a knowledgeable one, familiar both with my industry and its practices. The CFTC, I believe, has demonstrated over the past 15 years that it is knowledgeable. The SEC, on the other hand, especially in its recent rhetoric, seems to have demonstrated just the opposite, that it does not understand the futures business.

Nowhere is this more apparent than in the area of margins.

Margin Supervision

It seems to me that not everybody understands how futures are margined. If the committee will indulge me, I would like to review the essential ingredients of the procedure.

This morning, between 4:00 a.m. and 9:00 a.m., my staff in Chicago paid, or received, cash that was due to, or from, the exchanges on which we are clearing members. These payments or receipts were calculated on the basis of yesterday's gains or losses, not those of last week. At the same time, we have contacted each of our institutional accounts and informed them of the amount of money, which we call variation margin, that either they must pay or will be paid them. In the next few hours, those payments will be made over the Federal Reserve wire system.

Later this morning, my staff will again be contacted by the exchanges and told how much money we will be required to put up in anticipation of the next day's variation margin call based on today's price movement. On occasion, we ask our customers to do the same. In each case, the transactions are completed by the close of the Federal Reserve wire at 3:00 pm. Overnight, another calculation is made based on actual settlement, and the process will begin again early tomorrow morning.

In other words, we settle with the exchanges twice a day on a "cash on the barrel head" basis.

Come November, with the start of GLOBEX, we will actually have to settle three times a day.

In addition to variation margin, the daily or twice daily settlement in cash for gains and losses, I am required to collect from my customers a minimum initial margin or risk margin, as a good faith deposit to guarantee that they will meet their daily variation margin payments.

It is this margin that appears to be the focus of the current heated debate.

In a business in which gains and losses are settled once, twice, or three times a day, the purpose of the initial margin is to protect me if my customers are late for one or two days in meeting their variation payments. This is not my only protection, of course. I reserve the right to protect myself further by liquidating their positions if their variation payments are not forthcoming. I also reserve the right to collect initial margins that are higher than those required by the exchanges if I have reason to be concerned about the credit of any one customer.

Let me stress that these procedures and initial margins are set by people who are well acquainted with the workings and hazards of financial markets. Many of the world's major financial institutions have their representatives on the clearing house and margin setting committees of U.S. futures exchanges. A list of institutions represented on the Chicago exchange committees is attached for your information.

Quite frankly, this margin system is the strength of the futures industry; it allows all participants to trade on an equal footing as equal credits. The clearing house and its members insure each credit's performance. There is no playing field more level than ours, and there is no financial market with a more stringent set of financial requirements. The stock market, for example, settles every five business days (seven calendar days), even on margined transactions. The currency market and government securities market settle every day, as does the bank market. None of these markets settles more than once a day.

I should note that the strength of our margin system has, from time to time, influenced other markets to live up to the futures exchanges' standards.

In the early 1980s, for example, when the government securities industry encountered problems in the "term repurchase" market, a leveraged forward market, it changed to a repricing system in which monies flow between participants in a way that emulates futures variation margin flows.

U.S. futures exchanges also have influenced practices overseas where typically less regulated market brokers were free to lend even the initial margin to clients. U.S. exchanges have insisted that initial margins be in cash or liquid instruments or irrevocable letters of credit. It was at the Chicago Mercantile Exchange's insistence that the Singapore International Monetary Exchange (SIMEX) tightened its practices so that only third-party letters of credit would be acceptable as margin.

Over a long history, these stringent margin rules have produced an astonishing record. No customer has lost money because of a default to an exchange. In the off-exchange market, on the other hand, customers have suffered a string of losses because of counter-party defaults. Notable examples are the Herstaat default in the foreign exchange market, the Drysdale default in the government securities market, and the yet to be determined fallout for the swap and junk bond markets from Drexel's recent closure.

Most of these involved less regulated forward markets where the magnitude of problems was permitted to grow to large proportions. Problems do and always will exist in financial markets as participants become overextended, but our margin mechanism allows us to nip these problems in the bud. We detect problems early because we collect money immediately. As a result, problems are contained.

The SEC does not seem to appreciate the soundness of this system. The most recent evidence of this was the surprising suggestions that I and other members of my industry should lower margin demands in times of stress. Neither my shareholders, customers, nor my employees would think this is an appropriate action to take. For that matter, because regulated margins are always minimums rather than maximums, lowering margins would be an empty, futile exercise in a time of financial turmoil. My job is to protect the interests of my shareholders.

It seems to me that the SEC has confused private roles with public policy's need for our central bank, the Federal Reserve, to be the "lender of last resort," a role that it discharged admirably in the last two market breaks.

Off-Exchange Trading

The section of the bill that I found the most difficult to penetrate concerns off-exchange trading. Although the intent of this part of the bill is open to dispute, I am informed by people who should know that it would allow people to choose whether or not to be regulated. That is, under this part of the proposed legislation, people could create off-exchange markets in futures products.

In light of my comments on the integrity of the exchange margin system and its superiority to the financial practices in the off-exchange markets, I think that you can predict what my position is on this part of the bill.

I am against it.

Candidly, self-preservation motivates part of this position. At the same time, no one wants to be thought to be against competition, and I am not anti-competitive. Let me offer the following observations.

- I believe in competition within structures that are sound

- I believe the existing futures exchange structure is both sound and competitive.

Indeed, the industry may be close to the classic description of what economists call "perfect competition."

First, there are no barriers to entry. Many of the securities exchanges already have established companion futures exchanges. Further, futures exchanges are blossoming on the international scene with ever greater vigor.

Second, the number of payers in the futures industry is large, and there are no artificial barriers to individuals who want to be able to participate. As I indicated earlier, the playing field could not be any more level than it is in the futures industry. Moving futures trading to the off-exchange markets would put the business in the hands of those with large amounts of capital, and would deny access to those who are equipped only with intelligence and drive.

Third, the rates of return in the futures industry are low. The Vice Chairman of the Chicago Board of Trade recently was quoted as saying that the average return to futures commission merchants in 1984 was 8.1%. In 1985, the return was 3.99 percent, and most recently was estimated at 6.95 percent, a rate of return that hardly comes close to competing even with Treasury bills.

Concluding Remarks

Let me conclude by reviewing briefly the specific questions put to me in the July 19 correspondence from Senators Dodd and Heinz and offering my opinion on each topic.

- Is there a need for one regulator of stock and stock derivative instruments?

  No. "Functional" regulation has worked well. Coordination between the two agencies is important, but consolidation is not required.

Which federal agency is the appropriate body to regulate stock index futures?

The Commodity Futures Trading Commission. I feel the CFTC has shown that it knows its business.

To what extent, if any, does the current system of margin regulation for stocks, options, and stock index futures contribute to risk to the financial system?

I do not believe that stock index futures trading contributes to volatility. Neither the evidence that I have seen nor my intuition convinces me otherwise.

If there is a flaw in the system, it is that the margining and settlement practices on the stock side of the business are not as stringent as those of the futures industry or of other financial markets.

Should there be federal regulation or oversight of stock index futures margins?

My own view is that there is already tacit Federal oversight of futures margins. Those of you who have followed the development of stock index futures trading appreciate the sensitivity that the Chicago Mercantile Exchange in particular has shown for the concerns of the Federal Reserve. If anything, the Chicago Mercantile Exchange may have been overly sensitive to the Fed's concerns on this score. Today, stock index margins are quite a bit higher than is necessary to protect the financial integrity of the futures business.

Set against this is the position that the Federal Reserve has studied this issue at length and found no reason to interfere in the margin setting practices of the futures industry.

Thus, I would conclude that further Federal regulation or oversight of stock index futures margins is neither necessary nor desired.

[Is there a] need to modify the "exclusivity clause" of the CEA, to allow instruments with both futures and securities characteristics to trade concurrently on securities exchanges (under the federal securities laws) and commodity markets (under the CEA)?"

As I have indicated above, the proposed modification of the "exclusivity clause" would do a great deal more than this. It could well gut the futures exchanges and shift futures trading to the unregulated off-exchange market. The proposed modification has, I think, well overshot whatever mark the authors of the proposed legislation may have intended.

At the same time, I believe the CFTC has, on occasion, set up criteria to exempt itself from jurisdiction over "hybrids" such as swaps. This is healthy, as was the outcome of the Shad/Johnson accord. I would favor a mechanism that would allow for such compromises, but the proposed modification to the CEA is not it.

INTERNATIONAL FINANCIAL INSTITUTIONS

REPRESENTED ON THE

CHICAGO BOARD OF TRADE CLEARING CORPORATION BOARD OF GOVERNORS

First Boston
Goldman Sachs
Merrill Lynch

CHICAGO MERCANTILE EXCHANGE CLEARING HOUSE COMMITTEE

Banque Indosuez
Bear Stearns
Citibank Futures
Continental Bank
Chicago Research and Trading
Dean Witter
Daiwa
Discount Corporation of New York Futures
First Boston
First National Bank of Chicago
Harris Bank
Manufacturers Hanover
Mitsubishi Financial Futures
Shearson Lehman

Senator DODD. Thank you very much.
Mr. Kleckner.

STATEMENT OF DEAN KLECKNER, PRESIDENT, AMERICAN FARM BUREAU FEDERATION, WASHINGTON, DC

Mr. KLECKNER. Thank you, Mr. Chairman, members of the committee.

I am Dean Kleckner, president of the American Farm Bureau. I live and farm in Iowa, the neighboring State of Mr. Dixon and Mr. Bond. We are pleased to submit comments today.

Farm Bureau is the largest general farm organization in the country in that we represent all farmers, big and small, medium-size and growing all commodities, of the 300 or more that are grown in the country.

The Farm Bureau was very actively involved in the process in 1974 when Congress created the CFTC. We believed then, and very strongly continue to believe, that CFTC regulation of agricultural futures and options trading is an essential element of a mechanism to market farm commodities.

PRODUCTION RISK AND PRICE RISK

We farmers routinely face two distinct types of exposure, risk exposure—production risk and price risk. Production risk: weather-related. Not a lot we can do about it. As the Senators here know, whether last year in drought, this year in too much rain is devastating.

But, something that we can do something about is the price risk. I'm just saying that essentially, simply, a great year of farming can be wiped out by a poor day of marketing.

We farmers are essentially price takers. As individuals, we have limited control over the price we receive. The futures market offers farmers an opportunity to price their crops and livestock up to a year or more in advance of the time they will be physically marketed. I've done that myself a number of times.

When a farmer enters into a forward contract with a local grain dealer or grain elevator, as very often we do rather than doing it directly, that entity has to offer a forward contract. And the ability to do that is through the ability to transfer the risk to somebody else—the futures contract.

Futures contracts must be designed to meet the needs of farmers and must be based on a clear understanding of production factors, cash markets and producer needs. Agricultural input and oversight is guaranteed by CFTC regulation and review by the Agriculture Committees in Congress. We think this is essential.

Diluting or eliminating CFTC authority would threaten the long-term availability of an essential agricultural risk management tool.

Now, the current discussion of the differing margin requirements between stock and commodity futures contracts indicates to me that many of those involved in the debate are unaware of the concepts of price, risk, transfer, as has been successfully used in agriculture for over 100 years, forcing commodity hedgers to put up additional margin requirements would increase the cost of farmer-hedging and; if carried to an extreme, could literally wipe out the entire futures industry.

It's been argued that removing stock index futures from CFTC jurisdiction is not agriculture's fight and will have no long-term impact on the operation of commodity futures.

Secretary of Treasury Brady has stated before this very committee that he has no intention of asking for or encouraging the removal from CFTC jurisdiction of any futures contracts beyond stock index futures.

Based on our discussion with the Secretary, which we held just a few days ago, we are confident that he is sincere in this commitment. We are also aware that neither Secretary Brady nor any member of this committee will be in Washington forever. The Farm Bureau thinks, that it's reasonable to believe that, once the precedent is set for regulation of futures contracts by more than one regulatory agency, that there will, indeed, be efforts to move regulatory authority for other contracts.

Farm Bureau recognizes that other futures markets currently surpass the agricultural commodity futures in terms of volume. We see the figures.

However, we also know that market efficiencies to increase liquidity and low processing cost depend as much on the aggregate volume of the futures industries as it does in the volume of a given contract or category of contracts.

Consequently, we view the proposed action to disenfranchise to CFTC from the regulation of the stock futures contracts to have adverse implications for all futures contracts.

While it would be easy through a reorganization to create a situation where size determines emphasis, commodity futures markets remain an essential component of modern agriculture. Their size relative to other markets is important to producers, who depend on hedging techniques to transfer price risk.

Commodity futures market regulation by CFTC includes oversight by the Agriculture Advisory Committee and analysis by staff agricultural economists.

The commitment at CFTC is for a workable, responsive commodity futures market; separating the authority over commodity and financial futures markets would isolate CFTC and, undoubtedly, dilute the expertise they currently have.

If the regulation of financial futures is deemed inadequate, CFTC resources should be expanded. Again, let me emphasize that any attempt to lessen CFTC authority and credibility will diminish the use and effectiveness of futures markets for agricultural producers.

Mr. Chairman, we thank you for the opportunity to present this statement.

[The complete prepared statement of Dean R. Kleckner follows:]

AMERICAN FARM BUREAU FEDERATION
225 TOUHY AVENUE • PARK RIDGE • ILLINOIS • 60068 • (312) 399-5700 • FAX (312) 399-5896
600 MARYLAND AVENUE S.W. • SUITE 800 • WASHINGTON, D.C. • 20024 • (202) 484-3600 • FAX (202) 484-3604

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE REGARDING THE COMMODITY FUTURES TRADING COMMISSION JURISDICTION OF FUTURES MARKETS

July 24, 1990

Presented by Dean R. Kleckner
President

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE REGARDING THE COMMODITY FUTURES TRADING COMMISSION JURISDICTION OF FUTURES MARKETS

July 24, 1990

Presented by Dean R. Kleckner
President

Mr. Chairman and members of the Committee, thank you for the opportunity to represent the American Farm Bureau Federation. The American Farm Bureau Federation is the largest general farm organization in this country, representing more than 3.8 million members families in 50 states and Puerto Rico. We are pleased to submit comments regarding the current discussions of the role of the Commodity Futures Trading Commission (CFTC). AFBF was actively involved in the process in 1974 when Congress created the CFTC. AFBF strongly believed then and continues to believe that CFTC regulation of agricultural futures and options trading is an essential element of a mechanism to market farm commodities.

Farmers routinely face two distinct types of risk exposure. These are production risk and price risk. With respect to crops weather is the predominant component of yield risk and is largely beyond the control of the farmer. Although a good yield is an essential element of a price and quantity relationship that produces an adequate total revenue, it is clearly not enough. Quite simply, a great year farming can be wiped out by a poor day of marketing.

Farmers are essentially price takers. As individuals, they have limited control over the price they receive. The futures market offer farmers an opportunity to price their crops and livestock up to a year or more in advance of the time they will be physically marketed. Moreover, futures contracts are the driving force behind all price risk management. When a farmer enters into a forward contract with a local grain dealer or elevator, the ability of that enterprise to offer a forward contract is dependent on the ability to transfer this risk to someone through a futures contract.

Futures contracts must be designed to meet the needs of farmers and must be based on a clear understanding of production factors, cash markets and producer needs. Agricultural input and oversight, as guaranteed by CFTC regulation and review by the agricultural committees in Congress is essential. Diluting or eliminating CFTC authority would threaten the long-term availability of an essential agricultural risk management tool.

The current discussion of the differing margin requirements between stocks and commodity futures contracts indicates that many of those involved in the debate are unaware of the concepts of price risk transfer as it has been successfully used in agriculture for over 100 years. Forcing commodity hedgers to put up additional margin requirements would increase the cost of farmer hedging and, if carried to extreme, could literally wipe out the entire futures industry.

It has been argued that removing stock index futures from CFTC jurisdiction is not "agriculture's fight" and will have no long-term impact on the operation of commodity futures. Secretary of Treasury Brady has stated before this very committee that he has no intention of asking for or encouraging the removal from CFTC jurisdiction of any futures contracts beyond stock index futures. Based on our discussion with the Secretary, we are confident that he is sincere in this commitment. We are also aware that neither Secretary Brady nor any member of this committee will be in Washington forever. AFBF thinks that it is reasonable to believe that once the precedent is set for regulation of futures contracts by more than one regulatory agency that there will indeed be efforts to move regulatory authority for other contracts.

AFBF recognizes that other futures markets currently surpass the agricultural commodity futures in terms of volume. However, we also know that market efficiencies through increased liquidity and low processing cost depend as much on the aggregate volume of the futures industry as it does on the volume of a given contract or category of contracts. Consequently, we view the proposed action to disenfranchise the CFTC from the regulation of the stock futures contracts to have adverse implications for all future contracts. While it would be easy through a reorganization to create a situation where size determines emphasis, commodity futures markets remain an essential component of modern agriculture. Their size relative to other markets is important to producers who depend on hedging techniques to transfer price risk. Commodity futures market regulation by CFTC includes oversight by the Agricultural Advisory Committee and analysis by staff agricultural economists.

The commitment at CFTC is for a workable, responsive commodity futures markets. Separating the authority over commodity and financial futures markets would isolate CFTC and undoubtedly dilute the expertise they currently have. If the regulation of financial futures is deemed inadequate, CFTC resources should be expanded. Again, let me emphasize that any attempts to lessen CFTC authority and credibility will diminish the use and effectiveness of futures markets for agricultural producers.

Senator **Dodd**. Thank you very much.

We appreciate all of your statements.

Two of our colleagues have arrived, I would like to give them the opportunity to give opening statements.

Senator Shelby.

Senator **Shelby**. Mr. Chairman, I just have an opening statement I'll ask be made part of the record.

Senator **Dodd**. Without objection, so ordered.

STATEMENT BY SENATOR RICHARD SHELBY

Senator **Shelby**. Mr. Chairman, once again, I appreciate your scheduling another in this helpful series of hearings to explore the wisdom of transferring jurisdiction over stock index futures from the CFTC to the SEC. I believe that today's witnesses will be particularly helpful.

The three major changes that the Capital Markets Competition, Stability, and Fairness Act would accomplish have been billed by the administration and other advocates as a means to reduce volatility in the capital markets. Let me state from the outset that if I believed that to be true, I would be a cosponsor of this measure. If I had seen any convincing evidence that permitting the SEC and not the CFTC to oversee stock index futures would end 50, 70, or 100 point swings in 1 day, I would advocate this change myself.

If I believed, if I had been convinced that converse of what Alan Greenspan said was true, that the preponderrance of evidence did suggest that either margins in the cash market or margins in the futures markets have affected volatility in a measurable manner, I would support efforts to change the present system.

However, Mr. Chairman, that is not the case. Rather, instead, I see the administration creating a scapegoat. The administration knows that markets that go up also come down and the next time this market comes down, for whatever reason, be it our failure to achieve meaningful budget deficit reduction, or whatever other macroeconomic problem damages the outlook for short-term prosperity in this country, the administration will have a scapegoat. They can point to their legislative proposal that failed to pass and blame the volatility in the market on Congress.

In fact, I have to guess that the administration would really rather that this legislation didn't pass because then they would have no scapegoat. The advocates of this legislation know that it is extremely unlikely that these minor changes will enhance the stability in the market. But the next time we have a market break, they can fool the public into believing that this failed legislation would have made even an iota of difference.

And so, for reasons that are not quite clear, we continue to debate the administration's proposal. Proponents of this legislation have spent a great deal of time and money lobbying for the administration, raising the profile on an issue with no substance.

Mr. Chairman, I welcome today's witnesses and the light that I know that they will shed on this subject.

Thank you, Mr. Chairman.

Senator **Dodd**. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, thank you for giving me an opportunity to go back and make an opening statement. I have been downstairs engaged in what Congress does best, and that is spend money, with the passage of an appropriations bill, little of it for a good purpose, I might add.

Mr. Chairman, I appreciate our panel today. I have had an opportunity to look at their testimony and, needless to say, I find much in it that I agree with.

We have had many people now appear before the committee. But, I think the facts are very clear.

First of all, no evidence whatsoever from any credible source has been presented that indicates that stock index futures, either who regulates them or their existence, has any impact on volatility.

Second, despite all of the claims of the Securities and Exchange Commission, they opposed the initial trading of stock index futures. The constituency which ultimately they serve is hostile to stock index futures. The debate is fundamentally about completion. Those who are suffering from it want to eliminate it. Those who are benefiting from it want to continue the competition.

That is not directly our affair in this committee, Mr. Chairman. What we are about is trying to promote economic growth in sound financial markets. And I think, ultimately, when you cut through all the rhetoric, the issue is one of innovation versus regulation. The question really boils down to whether we want to have a unified regulator, whether that is our objective, or whether our objective is to have new and innovative products that keep America at the center of the financial world. And I think the answer is the latter.

Let me also say, Mr. Chairman, that I find it interesting that we continue to have this debate over margins. And I never cease to be amazed that people do not fundamentally understand the distinction between margins in a purchase of stock and margins in a purchase of a future contract.

I think the confusion comes in the language. I don't think we ought to be using the term "margin" in referring to a futures contract purchase.

When we are talking about margins in the purpose of a stock we are focusing on the amount of money that is, in essence, my downpayment when I borrow money to purchase stocks. That margin is set by the Federal Reserve Bank because it is part of the credit system. The margin involved when I purchase a future is more closely related to earnest money.

The complaint that we don't have harmonized margins, whatever that means, would be equivalent to me saying that something is wrong in that I could go out and obligate myself this afternoon to purchase in a million dollars of property for probably $10,000 or $20,000 on earnest money. But, if I actually go through with the purchase and I go out and borrow money, the money that I'm going to have to put down in downpayment is probably $250,000 to $400,000.

What we're talking about with regard to futures is earnest money that is paid up front, obligating me to pay every dime of my full obligation when that future matures.

And I think that is an endless source of confusion.

Finally, Mr. Chairman, let me say that I believe that, with all of the problems that we have, our time would be spent more usefully trying to make the system work better than being engaged in a jurisdictional dispute which, in my opinion, is ultimately not going to produce the change in policy that many advocates claim they want.

And I can't help but note that the Securities and Exchange Commission has been before this committee asking for massive powers to extend its regulation of banks if we move to allow banks into the securities industry. The SEC has plenty of work to do. the CFTC has a lot of work to do. These men before us today could have done more to reduce the deficit today than we will do in the budget summit if they were allowed to be back in Chicago or Kansas City or back on the farm doing their jobs and making America grow.

And so I suggest that we let them go back to work, earn money. We will tax it. [Laughter.]

And that then we will be promoting the public interest rather than spending all of our time talking about who is going to be a regulator.

Finally, and I appreciate the chair's toleration, we have had an endless amount of misinformation. The truth is that we are not the only country in the world that has more than one regulator.

If you really look at the British system, the British have five regulators of futures. The British have a far more "fragmented system" than we do.

And I never tire, as neither does my dear colleague from Illinois, of pointing out that the unified regulatory system in the savings and loan industry failed, while the so-called fragmented, what I would call overlapping and reinforcing system in the banks did not fail. I don't think we ought to miss that point when we are talking about trying to promote economic growth and prevent financial panic.

Thank you, Mr. Chairman.

Senator DODD. Thank you very much. I have a statement from Senator D'Amato for the record.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mr. Chairman, today the committee holds another hearing to consider the administration's Capital Markets Competition, Stability, and Fairness Act of 1990. This bill has been proposed by the administration to "design a regulatory structure for stocks and stock index futures that best serves the capital formation needs of our country."

The wide gyrations in stock market prices that we have seen during the last few years have convinced small investors that the stock market is too risky for them. When the little guy sees the market jumping up and falling precipitously, usually because of program trading by the big guys, then he realizes that he will probably just get run over if he ventures out into the street.

The lack of small investors is damaging to our economy and deprives many small investors of the returns that they ought to be able to enjoy in the market. Our Nation's economy needs the confidence of middle America and the activity of the small investor in the stock market to obtain the capital necessary to modernize our economy, improve our competitiveness, and build for tomorrow.

I am eager to help promote changes that will stabilize the stock market and help it attract the investment dollars of small investors around the country. I look forward to the testimony of today's witnesses. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Melamed, let me begin the questioning with you.

MARGINS ON STOCK INDEX FUTURES

On page 6 of your testimony, you state that, at current levels, margins on stock index futures contracts traded on the Chicago Mercantile Exchange are roughly, somewhere between 11 and 15 percent of the value of the futures contract.

Is that correct?

Mr. MELAMED. That's correct. They are presently around 12.5 percent.

Senator DODD. Now, correct me if I'm wrong, but as I understand it, for speculators, that margin figure is roughly 13.5 percent; maybe a little less than that.

Mr. MELAMED. Right. Somewhere in the area between 12 and 13 percent.

Senator DODD. And for hedgers, it's around 4½ percent?

Mr. MELAMED. Closer to 5, yes.

Senator DODD. All right.

Now, is it correct that the majority of the business, somewhere between 80–90 percent of the contracts traded, are in the hedgers area?

Mr. MELAMED. Well, actually, we——

Senator DODD. Is that not correct?

Mr. MELAMED. Well, it's somewhat correct. The retail end of our business is about 6 percent. However, as far as the margin differentiation goes, actually, about 20 percent of our market pay the speculative sum. In other words, much more than merely indicative by the 6 percent retail.

It would seem that only 6 percent should be paying the higher margin and the rest should be professional hedgers. But, in fact, we charge about 20 percent of those hedging entities the higher margin rate.

Senator DODD. You understand my point though, Leo.

Mr. MELAMED. Yes.

Senator DODD. You use the 13.5 percent margin figure and don't make a distinction here between speculators and hedgers. And since the bulk of the business is in hedgers and that's at about 4.5 percent, that number between 11 and 13 percent I just found to be a little misleading.

Mr. MELAMED. I was trying to respond to that. It's actually closer to 80 percent that is the hedger use of the lower margin.

EXCLUSIVITY RULE

Senator **Dodd**. All right.

I'll come back to that in a minute. But I want to jump quickly to the question on the exclusivity rule because I know this has been of particular interest to the Senator from Pennsylvania in light of the Chicago MERC versus the SEC and Philadelphia Stock Exchange case, which was decided by the seventh circuit.

That case has been characterized in a lot of different ways, as we all know. But, everyone seems to agree that it stands at least for the proposition that, if an instrument has characteristics of both a security and a futures contract, the exclusivity clause of the Commodity Exchange Act requires that the instrument trade only on a futures exchange.

Is that correct? Is that your——

Mr. **Melamed**. Under the Shad-Johnson agreement, correct.

Senator **Dodd**. That would be correct.

The concern I have here is that in the opinion as reported, the court says:

The effect of the exclusivity rule—and I'm quoting them here—"gives the futures markets the opportunity to block competition from an innovative financial product."

The concern is that the effect of the clause as currently written is to give the futures exchanges a virtual monopoly on all products that may have characteristics of both futures and securities.

And I wonder, Leo, if you might not comment on your concern that if you take away the exclusivity clause, then you end up with no regulatory operation over these hybrids.

It seems to me that should not be the conclusion. The conclusion is that someone ought to be regulating and deciding whether or not something is a futures or a stock.

And the option need not be that no one is going to end up regulating it.

But, aren't we, in effect, raising the point that Senator Gramm talked about here, competition? Have we, in effect, created a monopoly with the court's decision?

Mr. **Melamed**. Well, Mr. Chairman, this is, as you note, a complex area. But, in the particular case at hand, I must say that the American Stock Exchange as well as the Philadelphia Stock Exchange could have listed those products exactly as they intended to. Both exchanges have futures divisions where they could have been trading them today.

They could have applied to the CFTC for permission. The CFTC was perfectly willing to give them permission to trade it. But, they chose instead to test this object in court.

Well, the court readily found that it wasn't really an innovative product, as they claimed it was. It is a more or less copy of what the futures market invented several years ago very successfully. And they have tried, in fact, to call it a security innovation when, in fact, it's a futures market copycat.

The New York Stock Exchange did a similar thing. However, the futures market did not object because, in that case, there was delivery of the securities product.

And the New York Exchange applied to the SEC, was approved by the SEC and, in fact, is trading that product today. It is too simplistic a view to say that the CFTC can have it all when, in fact, you can discern which is a future and which is a security.

And the Supreme Court and the courts of the United States have been able to do so.

Senator **Dodd**. Well, I understand that, but I was trying to get at that point. The report of the court draws the conclusion, based on their own opinion, that it gives the futures markets the opportunity to block competition from any innovative financial product.

That's their quote, not mine. That's the court's opinion.

Mr. **Melamed**. If it is a futures product.

Senator **Dodd**. Well, but even if it has characteristics of a security, when you get into that area when the product is 50/50 or 65/35 security and future, no matter what it may look like, if it's got any characteristics at all of the futures, then that's it.

Mr. **Melamed**. Well, Mr. Chairman, it's a complex, difficult area. I imagine the words could be written so that it could be clearer to define one from the other. But, clearly, that is not the reason to make a major structural change and shift jurisdiction.

Senator **Dodd**. I'm just getting at that particular point. There are a number of issues here, and that's a major one. And it just seems to me that with competition as the concern, what we are doing is, in effect, shutting it down. We are creating a monopoly situation.

And if you're going to have competition, we've got to talk about it in broad terms here and discuss it in all features. That's the reason I raise it. But, nonetheless, it's one element. I wouldn't suggest to you that in and of itself would be the only reason we ought to be engaging in a change of jurisdiction. But it's an important point.

Mr. **Melamed**. It seems to me though, that in the alternative, futures exchanges can't list futures on individual stock such as IBM either. So there is a way you can define one from the other and keep both ends apart.

And I think it's been to the general health of the American sector, as my opening statement indicates.

Senator **Dodd**. I appreciate that.

My time is up.

Senator Heinz.

Senator **Heinz**. Mr. Chairman, thank you.

First, I just want to maybe clarify the record regarding a statement that was made earlier about United Kingdom securities and futures regulation.

Mr. Chairman, I have an article here from the Wall Street Journal by a London correspondent that's entitled "Regulators of UK Securities and Futures Markets to Merge," which explains that the five self-regulatory organizations all report to and are supervised by the Securities and Investment Board, an umbrella body in any event, but they're trying to merge the self-regulatory organizations.

It was my understanding that the Securities and Investment Board itself is supervised ultimately by the Bank of England.

I just think the record ought to reflect that information which I believe to be correct.

Senator **Dodd**. That article will be included in the record.

Regulators of UK securities and futures markets to merge

By Deborah Hargreaves in London

TWO of the City of London's regulatory bodies yesterday took the first step towards consolidating the diffuse structure of supervision of UK financial markets when they announced their decision to merge by early next year.

The Securities Association and the Association of Futures Brokers and Dealers said they would be able to monitor London's trading markets better as a joint body and that a pooling of resources would lead to speedier identification of risks endangering the financial system.

The City has five self-regulatory organisations which were set up to monitor different market areas at the time of the 1986 Financial Services Act, which set up a new regulatory system to oversee UK markets.

Banks, brokers and other participants in financial markets need membership of and authorisation from a self-regulatory organisation before seeking business. The organisations are supervised by the Securities and Investments Board, an umbrella body.

The AFBD is expected to form a futures enclave within the much larger TSA, where it will bring futures business into the mainstream of securities regulation. Whereas the TSA supervises firms dealing in financial markets, the AFBD also regulates commodities traders. The two bodies have about 40 firms which are common members and a further 60 which have separate subsidiaries reporting to them.

The merger, which requires approval by members, will provide significant cost savings for large firms which will no longer have to double up on their subscriptions. Both bodies number many international firms among their members.

It will be welcomed by members as reducing the bureaucracy associated with the regulatory organisations. It is likely to put pressure on other regulatory bodies to unite or at least pool resources.

Critics of the system of multi-regulation say it is confusing and leads to inefficiencies. However, when the system was set up, the SIB made clear its intention of keeping the number of regulatory bodies down and said it expected to see them merging as their business began to overlap.

The Investment Managers Regulatory Organisation (Imro), for fund managers, sees the most obvious overlap in its business with TSA and the AFBD.

The remaining two bodies – the Financial Intermediaries, Managers and Brokers Regulatory Association (Fimbra) and the Life Assurance and Unit Trust Regulatory Organisation (Lautro) – have many common interests. Lautro members were forced to pay part of Fimbra's costs last year when its budget ran short.

The link-up of TSA and AFBD comes as London's major financial futures and options markets – the London International Financial Futures Exchange and the London Traded Options Market – are expected to announce their own merger.

INDEX PARTICIPATIONS

Senator **Heinz**. I'd like to, Mr. Chairman, follow up on your questions to Leo regarding the index participations and the U.S. Court of Appeals decision, seventh circuit.

Leo, I thought I heard you say—I wrote it down. Maybe I got it wrong, but I wrote it down, that the index participations were, and you quote, you said: "The court found that they are not an innovative product."

Let me read you from the court's opinion. "The fact is," they say, "index participations are no less a future than it is a security, and no more."

It just doesn't fit, which is the whole point. It isn't supposed to be just like something else.

The IP was designed as a novel instrument so that it could offer attributes previously missing in the market.

I gather you disagree with the seventh circuit court?

Mr. **Melamed**. No, I don't. Novel, it is. Innovative, I'm not sure.

I mean, I draw that distinction. The innovation that occurred was when the idea of financial futures occurred. Everything after that is sort of carrying the ball forward. But, each time you do it, you're not really innovating, you're creating a new novel twist on it. This is a twist.

Senator **Heinz**. Well, let's kind of avoid the semantical battle, which I'm sure you are spectacular at. [Laughter.]

Senator **Heinz** [continuing]. As proven here today.

Let me just ask you, let me kind of reduce it to mathematics. You're saying that if something has just any portion of a futurity to it, it should be regulated under the exclusivity clause by the CFTC. Let me just ask you though:

From a public policy point of view, does it really make sense that an instrument or a product that is 99 percent a security and 1 percent a future has to be regulated by the CFTC?

Mr. **Melamed**. No. I would agree with you. And I don't believe that I would stand in favor of saying that everything that has any * * * futures market indication ought to be traded as a future.

It's just the question of how much. There's a degree involved here. We're talking about a product line that has a great many similarities to futures and one of the most important features of futures is simply that there is no delivery of the actual product—there was no delivery of the security.

The IP contract in fact, was identical to a futures contract except that the buyer paid 100% margin. So, that it's really a case of degree.

I would agree with you, Senator Heinz, that you can't go down to a point of 1 percent. Of course not. I don't know what that percentage is.

Senator **Heinz**. Let me save the question to the next kind of logical step. We're talking about hybrid products. Chances are we are not going to come up with a 99/1 one in the real world. But there are products, and there are going to be more products, with attributes of both the securities and futures.

And my question is:

As long as hybrid products are subject to regulation by either the SEC or the CFTC, why shouldn't the creators of new financial products be able to design a product for either? They could choose the Chicago open outcry market system, or some other market system, and let the market participants decide whether it's worth buying.

I address that to you and others in Chicago because you have been innovators. You've been financial innovators. And it would seem to me that, philosophically, you would be for letting the market decide as opposed to having a regulatory structure decide.

Mr. MELAMED. Well, Senator Heinz, I believe the best answer to that is that, in its wisdom, the U.S. Congress decided to divide the regulatory structure between the functional aspect of futures and the other side called securities.

Senator HEINZ. Well, as you can tell, we're having second thoughts, at least here.

Mr. MELAMED. Well, I think your thoughts were pretty good though the first time because [laughter] we have been copied everywhere in the world. So I don't think what you did was such a bad thing. In fact, it was probably an excellent idea.

Senator HEINZ. That's OK, but that's not an answer to my question either.

Mr. MELAMED. And that is?

Senator HEINZ. By the way, it would be nice if everybody said, you know, "Senator, Congress, you made a decision and, by George, it's always right."

And I would love if everybody would say that all the time rather than selecting the ideological——

Mr. MELAMED. I'm heartened to hear this, Senator—I'm glad to see that we can rethink these things. And I agree with you, perhaps we should.

But, can I ask a question?

Why didn't the Philadelphia Stock Exchanges choose to list it as a CFTC product line, since there would have been no objection to it?

Senator HEINZ. When the people from the stock exchanges were here a couple of weeks ago, I gather you all had the opportunity to appear with them. You could have asked people from the exchanges that question.

Unfortunately, I gather, you chose not to appear.

Mr. MELAMED. Well, I've asked them that question.

Senator HEINZ. Well, you should have done it on the public record, if you had been here just 2 weeks ago. I don't know if we could have gotten a table long enough to fit, but * * * [Laughter.] * * * we would have done our best to accommodate everybody. Alan Greenspan's name has been taken in vain by everybody, regardless of what point of view you're coming from here today. There is, just to let everybody know that I, too, read the sayings of Chairman Greenspan, when he was here last March testifying, he stated that the exclusivity clause, and I quote:

> * * * serves to discourage the development of new financial products that might be offered outside of the futures exchanges and tends to stifle the innovative process.

Obviously, some of you will disagree with that. Leo already has.

Mr. **Melamed**. No, wait. Now he's talking about off-exchange products. I do not disagree with him.

Senator **Heinz**. No, what he said is not just offered outside of the futures exchanges.

Mr. **Melamed**. That's right.

Senator **Heinz**. He doesn't say not on the securities exchanges.

Mr. **Melamed**. Well, but he does not say that either. And I think he's talking about the innovations that are occurring in the corporate world that are off-exchange products that, in many cases, are not futures and have not been considered futures. And the CFTC has, in fact, admitted that and accommodated them.

And there is a question where they would be regulated. But, that certainly is something that Mr. Greenspan is talking about. I would agree with that.

Senator **Heinz**. My time is expired, but I assume that if a product isn't regulated on the futures exchanges, isn't traded there, isn't regulated there, that there are two things that can happen to it. It can be an unregulated product like swaps. And many swaps are, of course, done offshore at the present time because, if you did some of them on shore, the exclusivity clause might be invoked. They'd have to be done in an open outcry market and that's not apparently the way you can do them economically.

But, the other alternative to doing them on a futures regulated exchange is to do them on another regulated exchange. It seems to me, if people are doing things on another regulated exchange, there's no harm in that.

Your implication, of your comment, was it's always better to have people do things in an unregulated exchange if they're not going to be on our exchange.

I don't really think you mean that.

Mr. **Melamed**. I don't think I said that, Senator.

Senator **Heinz**. No, that was the implication. You didn't say that. It was the implication. That's what I wanted you to clear up.

Mr. **Melamed**. I certainly wouldn't subscribe to that implication either. I believe that the marketplace has room for both.

Senator **Heinz**. Thank you, Leo.

I apologize to the rest of you that I got into this extended discussion with Leo, but he is an expert and he has quite a track record and career, which is really remarkable. He has every right to be proud of it.

Mr. **Melamed**. Thank you, Senator.

Senator **Dodd**. Thank you, Senator Heinz.

Just to make a point, I should have addressed this earlier, and Senator Gramm may come back. I think we all know that margin or futures and stocks are different. But, whether it's margin on a future or margin on stock, the issue here is that both margins are the entry fee into the market.

And I think we can get into a debate about how many angels dance on the head of a pin, but, nonetheless, the margin is the entry fee. And whether you're participating in stocks or futures, that's really more the nub of the question, it seems to me.

Mr. Chairman.

The **Chairman**. Thank you, Senator Dodd.

You've received many compliments today, Mr. Melamed, and particularly—and you always have to be careful and wonder what kind of ground you're on when you're getting this barrage of compliments.

The other day, when Tom Eagleton was here, our former colleague—I'm sure you've read his testimony. But, he also paid you a personal compliment in the sense of saying that, from his association with you, that he thought that you were a genius, or words to that effect. And he said that, in fact, that you were actually——

Mr. **Melamed**. I demure. [Laughter.]

The **Chairman**. He said that you were actually more brilliant than Henry Kissinger thinks he is. [Laughter.]

Which I thought was really quite a standard to have set.

Let me ask you this question. We've talked before about trying to understand the impact of margin and the way it's used in the futures market versus the underlying securities market, and the difference in the clearance period, which has been pointed out today, daily clearance versus over a period of several days in the underlying stock market.

If the stock market is going down sharply, as it was in the early trading yesterday, and a major trader, sees that market going down further and wants to sell into that situation with the thought of the market going even further down, is there any advantage to that person in terms of the speed of the transaction and the leverage involved?

SELLING IN THE FUTURES MARKET VERSUS THE STOCK MARKET

I'm talking about the psychology that would be in place on a day like yesterday, of selling, say, an S&P index in the futures market versus selling some market basket of stocks in the underlying stock market?

Mr. **Melamed**. Is that addressed to me?

The **Chairman**. Yes.

Mr. **Melamed**. The question has been asked many many times, and been answered many many times. Indeed, there are 65 academic studies that indicated that margin is not the issue.

The **Chairman**. Forget the margin for a minute. I'm saying that if you're a trader yesterday and you want to sell into the face of that market, and you think it's going to go lower, is there any advantage to you to sell either a composite of stocks in the stock exchange market, or to come over the deal in your market?

Mr. **Melamed**. The issue is more liquidity and rapidity of coverage, rather than the issue of margin or leverage. Big institutional users that have come to use our markets have found that they have breadth of coverage, they have liquidity, and they have the ability to act quickly on the basis of new information as that information becomes available in today's technological world.

The **Chairman**. So can they trade faster in your market than they can trade a cross section of securities. If there's a market break and they want to get ahead of that and they want to be able to participate in that, is there any advantage for them in trading your market versus the underlying stock market?

Mr. MELAMED. Well, they have a choice of three markets, actually. When you say, our market, we represent the futures market. There's also a side by side options market that's regulated by the SEC. Many institutional player use that market in given moments of need, as well as the futures market. But in both cases, they have found an advantage in covering themselves in a broad way rather than hitting individual stocks that are much more volatile and, much less liquid. Institutions have found an advantage in using both stock index options as well as stock index futures market. We have found the users of our markets to be large money managers, pension fund managers, and mutual fund managers. They use these markets because we offer them the kind of service they need in today's world.

The CHAIRMAN. Well, that's what I want to get to. I want to understand a little bit better the dynamics of what happens when the market breaks, as it was doing yesterday. And whether or not there's advantage to the sophisticated trader, whoever that might be, an institutional investor or whoever, to come to your market because your market is faster, provides a product option in terms of dealing with a rapidly falling market, that is a more attractive place to come and trade than some other place. And I suspect that it is for many and that in fact, you see that start to happen.

Now, is that accurate, or not?

Mr. MELAMED. Well, it is accurate but I think implicit in your question is the issue of whether the small investor has indeed left the marketplace to the big money manager.

The CHAIRMAN. Yes, but let me leave the small investor out for the moment. I'm more interested in trying to understand the dynamics of how these separate markets work. They're connected but they're separate, how they work at a time of a market break. And its seems to me that if I were a major institutional investor and I wanted to sell a cross section of securities and I wanted to do it in a hurry, because I felt that the market was going down and I wanted to get out now, and maybe even cover my activity later at a lower price level, that I might be more attracted to your market because you offer the advantage of being able to do that, do you not?

Mr. MELAMED. No, you can do that in program trading. In fact, program trading, which is often misunderstood, is thought to depend on futures trading, but program trading was a mechanism used in the stock market long before there were futures, and is used today. It is used today, in other words, to sell a program, a program of stocks that can be sold that have nothing to do with futures trading.

The CHAIRMAN. I understand there is that option. I'm trying to decide for somebody who's got to make the choice as to whether they go that route or come to you and come to your market and use——

Mr. MELAMED. I think they use them all.

The CHAIRMAN. Well, I suspect they do. But I'm interested in understanding if, at certain times, there's an advantage that your market offers and that maybe in fact part of the commercial success that's been achieved is because you've found a way, at particular times, to have an option available to somebody in that situation that may in fact be more attractive than is available some other place. And therefore, they come to you. And the volume of traffic may very well go up at that time, simply because of the efficiency that the kind of trading instrument that you offer is greater.

I'm asking that as sort of a rhetorical question, but wouldn't that be an accurate way to look at it?

Mr. **Melamed**. The money managers' choice of markets depends on liquidity price, and efficiency. Futures, options, and securities markets are used in varying considerations to meet the immediate needs of money managers. And, as a matter of fact, in our market, he's got to find as many buyers as he does sellers, because in our market, there must be a buyer for every seller, so that he uses our market in both ways; to sell, as you indicate, as well as to buy.

And I really don't know that I can characterize our market as the only place he would come, because that's simply not the case.

The **Chairman**. No, no. I'm not saying the only place. I'm trying to understand whether there's a comparative advantage, in that kind of a situation, that your market affords. And if I can just take this one step further. I mean, these are complicated subjects. You can't get through them in 5 minutes. I'm not sure you can get through them in 5 hours. But I want to try.

There's a Wall Street Journal piece today, and the headline on the piece is "Trading Halt Breaks Steep Stock Slide." And then it says, as follows: "The circuit breakers that have gradually been added to financial markets since 1987 got their toughest test of the year, yesterday. They passed." And then dropping down in the article, it says, "selling pressure was concentrated on the Chicago Mercantile Exchange where futures on the Standard & Poors' 500 stock index are traded. At 10:34 a.m., the S&P futures had sunk to 252.80, down 12 on the day. That decline was enough to trigger a Merc circuit breaker that blocked any S&P futures trading at lower prices for 30 minutes." We've talked about that before. And then someone's quoted as saying, "Merc's restriction certainly broke the decline, said Ron Beckley, a stock trader at Montgomery Securities," and so forth.

Just continuing on in this piece, and I'm taking some of the logic out of the piece by skipping over some other intervening parts of it, said, "the Merc circuit breaker did exactly what it was supposed to do," said Jay Holman, head of futures trading at Donaldson, Lofkin, Jenrette. Then it drops down, and "although stocks in futures spent the rest of the day deep in minus territory, the remainder of the trading was far more orderly." And it goes on to talk in this vein.

Now, what I'm getting at is this: If this is an accurate assessment of what happened, and you can comment on that, and in fact the circuit breakers came into place, it had an effect of slowing things down and creating a more orderly process and more time for information to pass and so forth and so on. One might argue that in the absence of a circuit breaker, there may well in fact be something in the dynamics of a sharp break in the market where there is an inherent efficiency to a trader that's available in your market, when you've got the rush for the exits, and you've got a lot of sellers and more sellers than can be managed, that sophisticated traders may very well say to themselves, the futures market is the place to go and to move right at this particular time.

Now, there's always this subsidiary question of what's the play back and forth between the two markets in the course of a trading day. Now, I think you make a very good point when you say, nobody can come in and trade on one side of a futures contract unless somebody takes the other side of the futures contract. And I think it's a very compelling point because, in a sense, you can't have any transactions unless somebody's willing to take the other side of the transaction.

On the other hand, I think it's a fair question to ask, what would have happened in the absence of the circuit breaker, yesterday?

CIRCUIT BREAKERS

Mr. **Melamed**. Well, the circuit breakers are the result of something that futures markets have learned from I would say over 100 years. And we've learned that in moments of panic, a circuit breaker or a stop that helps the investor reorganize themselves, rethink the situation, learn more of the facts, slow things down, is very healthy and very beneficial. It was the recommendation of the blue ribbon panel of the New York Stock Exchange that in fact suggested that these circuit breakers be instituted across all markets, including the cash market, and that they be made even smaller in terms of increments than they presently are.

The Chicago Board of Trade and the Chicago Mercantile Exchange just recently signed off on adopting the New York Stock Exchange's own recommendation and sent the proposed rules to the CFTC. This has not yet been done on the SEC side, I might mention. The New York Stock Exchange and the other securities exchanges have not acted on their own recommendation. We have.

And yesterday was a very good example of how well the circuit breaker functions.

The **Chairman**. Well, yes, but I want to pursue this. Because I don't dispute the point that you just made, but it seems to me that in effect that's also an implicit argument for saying that, if there were no circuit breakers, who knows what kind of races we were off to yesterday. In other words, it seems to me, I think there may well be an inherent trading efficiency in your product, in your market, at a time of extreme stress like this, that may in fact bring a body of traffic there faster.

Now, I don't know that for a fact because it's very hard to assess whether that's so or not. But it seems to me that by arguing that the circuit breaker was effective, I mean, why was it so effective? I mean, the fact that it was effective has a story behind it that's bigger than the fact that it was just effective.

Mr. **Melamed**. Well, the reason it was effective is because it allowed buyers and sellers time to react. But you know, at the New York Stock Exchange, the market continued to go down long afterward, so that it took awhile to really affect the New York Stock Exchange cash market. Eventually both markets steadied, and that report is generally correct as to what happened.

And it is a tool; it's a tool that we learned over time to use. I think that it is an important tool. And if you are saying, Senator

Riegle, that in fact our futures markets and options markets are efficient markets, you're right. Sometimes they act as the messenger, because it is the place that will receive information first, and money managers will often use this market to act first. And therefore, it is the messenger that spreads the news. Sometimes it's not happy news.

When MacDonald's had bad earnings, or not as good earnings as expected, or when, on October 13, 1989, the UAL takeover wasn't about to happen, that was bad news for the market. We usually take the hit first. You really have to almost say, thank God there is a place that in today's technologically oriented world, there are markets like futures and options that can take that kind of hit, that take the first brunt of the selling and then find a way to steady the rest of the market. I say, we functioned extremely well.

The **CHAIRMAN**. I thank the chairman for his patience and my colleagues. I mean, it's very difficult to try and follow through on any kind of a back and forth within the time periods on a subject as complicated as this, and I appreciate the courtesy of the committee.

Senator **DODD**. Not at all. Thank you, Senator.

Senator Bond? I'm going to follow the pattern here, with all due respect to my other collegues.

UPTICK RULE AND THE FUTURES MARKET

Senator **BOND**. Thank you, Mr. Chairman.

Mr. Melamed, you stated on page 9 of your testimony, I believe you mentioned orally, that an uptick rule in futures would simply end the futures market. Now, we've heard a number of people in other sessions testify that one of the problems that we have is that there's no uptick rule for futures like there is on the Stock Exchange.

It would be helpful—pardon?

Mr. **MELAMED**. That was in Mr. Mahmlann's testimony.

Senator **BOND**. Ah, Mr. Mahlmann, sorry. Mr. Mahlmann, I apologize. Let me address the question to you.

Could you give us an explanation for our edification as to why an uptick rule on the entire index, rather than for indiviudal stocks within the index, would not work? Why would that be impossible for the futures market to adopt to?

Mr. **MAHLMANN**. Senator, I'll pick on the S&P 500 index, which is my colleague's product. But in order to establish a short sale with that kind of a requirement in it, there is at no time can we ascertain nor legislate, if we tried to, that all 500 stocks would have an uptick at a given particular time, therefore a short sale could not occur.

Senator **BOND**. What about the entire index? What about the index, itself?

Mr. **MAHLMANN**. I think what you again have to look at is futures market perform a price risk transfer mechanism. And Senator Riegle just addressed, I think, some of the major attributes for futures contracts. To transfer price risk, you want to do it fast, meaning immediacy of access. You want to do it in a liquid market, meaning the best price for the consumer. So if the General Motors

Pension Fund wants to hedge for its pensioners, it wants to get there fast, it wants to get the best price, it wants to find liquidity, and it wants to do so cheaply.

The New York Stock Exchange study from a couple of years ago pointed out the cost efficiencies of futures on a per cost of transaction size, on the immediacy, and on the liquidity, thereby achieving the best price to the producer. If I cannot hedge, and this goes over the whole concept of hedging, whether that be a corn contract or a bean contract or a stock index contract, if I cannot hedge on a down tick, I cannot price protect myself. Whether that be my farm of what I grow or my pensioners whose money I happen to manage.

Senator BOND. Let me just followup to ask the question. On the New York Stock Exchange, that same institutional holder could not go in and sell short a particular stock, unless—you cannot consummate a short sale unless there had been an uptick. Why could not the same requirement apply on the index, as applies on the individual stock?

I think there's a basic misunderstanding and I'm trying to get to the bottom of it, so we can perhaps resolve this question here at the hearing.

Mr. MAHLMANN. Senator, I think you'll have to also superimpose that the 500 stocks composed in the index have probably 500 times the volatility collectively than the index has a broad measure. That would have to be superimposed.

Mr. MELAMED. May I also respond, Senator Bond. Since you are comparing the New York Stock Exchange or securities market versus the futures market as it relates to an uptick rule. I think a better comparison, if I might, would be the options markets. Because the options markets are much closer aligned and more similar to the futures markets, you will agree. And in fact, there are so many similarities that take a long time to explain right now. But those are the markets that are most comparable.

And, as you know, the options markets are SEC regulated, and yet the SEC knows and understands that no uptick rule is possible in options markets and, indeed, does not exist. Now, this is an SEC regulated market and there is no uptick rule in any of the security-type options or on stock index options. And the reason for that is that these markets do not lend themselves to an uptick rule and can function effectively as they're supposed to.

The SEC recognized this and anyone who asks this question must compare apples to apples. The options markets cannot and the futures markets cannot adequately function under an uptick rule. Both the SEC and the CFTC recognize this.

Senator BOND. Well, I appreciate your explanation.

I had a couple of other questions I was going to ask. Let me try and ask one more to Mr. Kleckner. Last week, we had testimony from a number of retail stock organizations. Edward D. Jones & Company said that their research showed that among the many small investors they had around the country who were concerned over major market breaks, were quite a few farmers. And I think Mr. Bachman said that a Virginia farmer said, he was getting out of the stock market and staying in livestock because he could eat it if the price dropped dramatically. And a dairy farmer said, the market's getting jerked around. He wasn't going to be in the stock market if milk prices were this way, he wouldn't farm. Charles Schwab said, 70 percent of the people they surveyed felt that the destructive aspects of program trading needed to be brought under control, and of course, they were arguing that all of the regulations should be brought together in the SEC, both the futures index and the stock.

But, let me ask you on behalf of the many farmers you represent, are they concerned in their investment activities about the volatility in the markets? What do you see as you talk with your members or hear from them about the question, absent a change in jurisdiction of stock index futures from the CFTC to the SEC?

Mr. KLECKNER. Senator, I frankly don't hear very much from members on this issue, and I'm all over the country all the time talking to farmers and ranchers. A number of them may have substantial stock portfolios. If they do, they don't talk to me about it. What we talk about is some volatility in the agricultural markets. And I think that volatility is at least as great, if not greater, than in the stock market.

It just seems to me that the question here today—and I've been fascinated by the discussion; haven't understood some of it, frankly, but am fascinated by it anyway.

Senator BOND. You're not alone.

Mr. KLECKNER. Senator, what we're concerned about, I think, in farming is in the CFTC and related to agriculture in this whole area, is that the CFTC needs to remain a substantial operation. And when you start removing parts of it, transferring it for various reasons, you just make a less viable operation. Even though I heard Secretary Brady tell me in person a few days ago that he wouldn't ask for any more movement than what is contemplated here, I just wonder if this isn't the first crack in the dike. Secretary Brady won't be here forever and neither will I or anybody else in this room.

I can recall when the individual income tax started, it was promised to all of us that it wouldn't exceed what? 2 or 3 percent? That was a God given promise, and I just pay slightly more than that today. So I think that once you start, you sin a little bit and then it's easier to sin from there on. And I think, in this case, it would be a mistake to do what the bill does.

Senator BOND. I would agree.

Senator DODD. Kit, would you just yield on one point. I just wanted to follow up on that.

As I understand it, your real concern is the nose of the camel. I mean, frankly, the Farm Bureau's interest in what happens between stocks and stock index futures and the exclusivity rule, is not exactly what you'd call a compelling farm issue.

Mr. KLECKNER. True, true.

Senator DODD. So it's the nose of the camel under the tent. You're fearful that this is going to lead to other things where it does become a farm issue. That's your primary concern?

Mr. KLECKNER. Senator, yes, I think so. The other gentlemen on the panel here understand the exclusivity rule and all the rest of it much better than I do. I don't understand that very well. But you said it, we're concerned at the nose under the tent, and I just think it will happen, despite the promises that it won't happen.

Senator **Dodd**. But with respect to your opinion on stock index futures, stocks, and the exclusivity rule, you really don't have a view on that?

Mr. **Kleckner**. No.

Senator **Dodd**. Thank you.

Senator **Bond**. I think we'll be able to develop something that may satisfy Mr. Kleckner's concerns, and we'll look forward to having your support.

Thank you, Mr. Chairman.

Senator **Dodd**. Senator Dixon.

Senator **Dixon**. Thank you, Mr. Chairman.

Mr. Kleckner, in your remarks, you testified, quite properly, that the Farm Bureau is the largest repsesentative organization in this country for the ordinary farmer in America. Isn't that true? And you were a participant, Mr. Kleckner, in the preparation of these letters, the first of March 27, 1990, and the second letter, after all of the farm groups had met with the Secretary of the Treasury, dated July 10, 1990. Is that correct?

Mr. **Kleckner**. Yes.

Senator **Dixon**. And you support thoroughly at this point in time, just as you always have, the views expressed in those letters. And I'd note, Mr. Kleckner, that not only you and your group, the American Farm Bureau, but other groups, the National Farmers Union, the National Farmers Organization, I don't know what the words conservative and liberal mean because they're misused a great deal in the political arena and in political discussions, but I would, I think successfully argue that those kind of groups pretty well represent all the different philosophical expressions of different points of view by farm organizations in America. Is that a safe statement?

Mr. **Kleckner**. I don't know of any points of view that wouldn't be represented on either side of the liberal conservative spectrum than by those organizations.

Senator **Dixon**. Than by those organizations. And I hold in my hand these letters, 24 farm groups in America, every single commodity; the grange, the Farmers Union, your group, all of them, everyone of them signed this.

Now, the other day when the administration was here, they kind of wanted to imply that maybe you don't know what you're doing here. You know, maybe you're in over your head. I would argue that every farmer in America is a businessman in his own right. They have a pretty big job operating their own separate little businesses as a farmer. I take it, your groups thought this over pretty carefully before you got involved in this dispute. Is that not true?

Mr. **Kleckner**. Senator, if you know anything about the Farm Bureau, and you do, you're from Illinois, you know that we don't move precipitously any time. We move rather slowly and think things out, and this is another case where we didn't just jump in and——

Senator **Dixon**. Exactly true. I happen to be on a flexibility amendment right now with Chuck Grassley. There's some little difference between the American Farm Bureau and my own Illinois group. You're still discussing it. We're going to argue the amendment tomorrow, so you're pretty thorough.

But the point I want to make is, is there any question about the fact that you knew what you were doing in this case? You're satisfied about your position, are you not?

Mr. KLECKNER. Yes, we're satisfied.

Senator DIXON. Well, the reason I asked that is, we're here listening to a lot of testimony from all sides on S. 2814. I suspect that bill's never going to emerge from committee in the first place; it's not even in this committee; it's in the Agricultural Committee where it belongs. But beyond that, I would call your attention to the fact, which you well know, that on the floor now we still have the CFTC bill with broadened powers and additional funding, S. 1729, and the SEC bill with additional powers, S. 648, both designed to deal with marketplace problems.

Sometime eventually we're going to call those bills. And of course, it's just as sure as it can be that when that happens, this whole question is going to come up. Now, I'm going to be involved in that fight. Others here will be, I expect, and I am going to argue to my 99 colleagues and friends on the floor of the U.S. Senate, that the American Farm Bureau and the other 23 representative groups of every farm group in America are unalterably opposed to the transfer of stock index futures jurisdiction from the CFTC to the SEC.

Is that a correct statement of the position of every farm group in America?

Mr. KLECKNER. Can't speak for the rest of them, other than on the letter, and they may have changed their minds; I'm not aware that they have. But, as for the Farm Bureau, which I can speak for, you're correct.

Senator DIXON. I thank you very much.

May I ask you this question, just as I would hope Senators don't worry that much about the score cards. This Senator tries not to, and I want to ask you this question.

Would this be a vote that the Farm Bureau would be concerned about on the floor of the U.S. Senate?

Mr. KLECKNER. I think so, Senator. We do have scorecards, as you're well aware.

Senator DODD. I'll tell you, if you don't, Alan Dixon does.

Senator DIXON. Well, I just want to tell you something. Mr. Kleckner, put this one on. [Laughter.]

Mr. Petersen, you were going to say something a while ago.

Mr. PETERSEN. In reference to the joint agriculture letters, when we prepared the first joint letter earlier in the year, around the end of March, we had 18 cosigners. I wanted to explain to you the depth of the feeling among the agricultural community, because we prepared that draft letter and in just a few days we had 18 cosigners. I think this is remarkable for anything involving that number of people.

Senator DIXON. Well, I appreciate that, Mr. Petersen. I appreciate the remarks of Mr. Kleckner earlier and in other testimony, too, where he indicated that he doesn't understand every bit of this, but he knows the position of the Farm Bureau. And I want to say, even on this committee, most of us do not have the expertise to understand all this, and we probably have a little more than the average Senator out there on the floor that has not heard all this testimony. I suspect when you get across the Potomac River and outside the beltway, most people in America just think this is Wall Street and LaSalle Street fighting. But I want to make it clear that I can represent to the U.S. Senate that for the groups that represent every farmer in America, you see this as an issue of significant importance to farmers in America.

Mr. **KLECKNER**. Yes, it is.

Senator **DODD**. Any more questions?

Senator **DIXON**. I'm thoroughly satisfied. [Laughter.]

Senator **DODD**. Senator Gramm?

Senator **GRAMM**. Thank you, Mr. Chairman.

Well, Dean, let me say the reason we're showering you with all these questions is where I'm from, the farmer's got only three friends in the world: Sears & Roebuck, God Almighty, and the Farm Bureau. And so what you think, we take important.

Senator **DODD**. Not in that order, I hope.

Senator **GRAMM**. I don't know. Maybe not in that order. We're not dealing with Sears today. Maybe I ought to change the order. I could always change it back.

MARGINS ON CATTLE AND AGRICULTURAL COMMODITIES

I want to touch on a couple of other angles here, quickly, Dean, that are related to this. The first is, do you view the margins on the sale of agricultural commodities and cattle as being too low and producing volatility?

Mr. **KLECKNER**. No.

Senator **GRAMM**. Would you like to see them raised?

Mr. **KLECKNER**. No.

Senator **GRAMM**. Would it concern you if I said that the margins are roughly equivalent to the margins on other futures and that if the SEC raised margins on stock index futures there might be a strong argument that, if that is supposed to promote stability in stocks, then maybe we ought to raise the margins on cattle and agricultural products?

Mr. **KLECKNER**. Senator, that would concern me very greatly and I think that's waht is likely to happen, not perhaps immediately, but I think you would have a hard time perhaps arguing against that. All I know is that from a farmer's point of view, one who has used the futures occasionally, I don't do it consistently, I'm a family farmer that markets its corn, soybeans, and hogs on my farm, and I market hogs probably every 2 weeks of the year, so it's a fairly regular basis that I'm on the cash market with live hogs now, but the futures market is a tool that we use, and farmers don't understand it, kind of hate to use it, and the margin requirement—whether that's a proper word or not, I don't know after listening to the testimony and the comments—but the margin requirement is a detriment. And if it were raised, it would mean that even fewer of us farmers would use that tool than we use it now.

Senator **GRAMM**. Let me continue my line of questioning.

Obviously, you're concerned about the viability of markets where your futures are traded?

Mr. **KLECKNER**. Yes.

Senator **Gramm**. I have here a letter, Mr. Chairman, from the Kansas City Board of Trade, where they talk about the impact on their viability if we had the elimination or a substantial reduction in stock index futures trading. They say that the impact of the loss on the exchange would be profound.

Would you be concerned that the transfer of jurisdiction, and a subsequent increase in margins and the stifling of a product that the SEC never wanted to trade, might threaten the viability of an agricultural exchange, such as the Kansas City Board of Trade, and directly impact on farmers and the viability of their markets?

Mr. **Kleckner**. Yes, Senator, I'm very concerned about that. We need a viable market, we need it to be low cost, and by doing any of these things, raising the margins or transferring part of the business way, you are obviously increasing the cost, either directly or indirectly there, and I think you are threatening the future of the market.

Senator **Gramm**. In fact, I think you could probably argue that if you had the loss of stock index futures as a viable product, then in all of these markets that trade your futures agricultural futures would have to carry more overhead and the cost of their trading might well go up, hurting every farmer and rancher in America.

Mr. **Kleckner**. I think that's got to happen. The costs are there, the overhead costs are there, and when you spread those over fewer transactions or less volume, the cost just simply has to go up. When I raise 150 bushels of corn per acre versus a draught year of 75 bushels of corn per acre, my cost per bushel is higher the year I raise 75 bushels. You just need the volume.

Senator **Dixon**. Absolutely.

INTERNATIONAL COMPETITION

Senator **Gramm**. Well, let me change the direction of my questioning to move toward international competition. I think one of the things that we have all had to learn to live with her is that we are in a world market. So decisions that we make here not only affect the viability of individual markets in this country, they affect our ability to compete internationally.

Leo, I was looking at an article that was in the Wall Street Journal on March 4, where the London International Financial Futures Exchange was working to promote a merger with the Stock Exchange Equity Options Market. One of the objectives of the merger, as they say, is that it would mark a victory for the futures exchange which has resisted attempts to be absorbed into the stock exchange's bureaucracy.

How strong is foreign competition that we are facing in futures markets around the world? What percentage of the overall futures market, if you know the number, do we currently have operating in this country?

Mr. **Melamed**. Well, you are exactly right, Senator Gramm. International competition is, indeed, what we worry about most. In fact, with some pride, I can tell you that the two major futures exchanges, the Chicago Board of Trade and Chicago Mercantile Exchange, recently unified an international transaction system that will allow us to compete on a 24 hour basis with the world, and trade our products on a 24 hour basis. It's called Globex and it'll be a way that we can compete internationally—with Tokyo, the British futures exchanges, and other futures exchanges around the world.

U.S. market share of total world futures and options volume has fallen from 100 percent just 5 years ago to just 64 percent last year. That is a clear indication that the rest of the world has taken our market seriously and that they are copying everything we've got and marketing it.

And indeed, I might also add something—you didn't ask this—but the margins on stock index futures contracts in Osaka and Tokyo are substantially lower than they are in Chicago.

Senator **Gramm**. I knew it. I knew it. [Laughter.]

Mr. Chairman, let me end with one final, quick question.

Is there any evidence to substantiate a claim that someone could make that the settlement process for stock index futures, with the margins that have existed, has ever in any way been more threatened than the settlement process for stocks?

Mr. **Melamed**. Well, I think I can just point to the fact that the history of our market, prudentiality in margins is one that is really impeccable. We have not threatened the financial integrity of this Nation ever once, even with the fact that not one of our member firms has failed in any kind of financial way as a result of the margin structure that we have.

Senator **Gramm**. Thank you, Mr. Chairman.

Senator **Dodd**. Senator Sarbanes.

Senator **Sarbanes**. Thank you very much, Mr. Chairman.

Mr. Kleckner, were you involved at the time that the CFTC was established?

Mr. **Kleckner**. No. Personally, I—that was 1974, if I remember correctly.

Senator **Sarbanes**. Right.

Mr. **Kleckner**. And I was—that was 16 years ago. I was not even president of Iowa Farm Bureau yet at that time.

Senator **Sarbanes**. OK. I take it, you know some of the history of that. At the time, was it anticipated that the commodity futures market would embrace financial futures as well?

Mr. **Kleckner**. No. I don't know that history.

Senator **Sarbanes**. Well, since they were developed subsequently, I think it's fair to say it wasn't anticipated.

Mr. **Melamed**. Senator, if I might?

Senator **Sarbanes**. Did you anticipate it?

Mr. **Melamed**. Yes, we did because the very——

Senator **Sarbanes**. Well, that's why Senator Eagleton said the other day that you were as smart as Henry Kissinger thinks he is——[Laughter.]

Which is saying quite a lot. [Laughter.]

You foresaw it, did you?

Mr. **Melamed**. Yes, we did, Senator, because we applied for our very first contracts in currencies in 1972, ultimately to the CFTC. And the first new contract that the CFTC devised was the Treasury bill contract in 1976. That was their first authorization of a financial future. And that was just 2 years after the inauguration of the CFTC.

Senator SARBANES. Did the Farm Bureau foresee it, Mr. Kleckner? Do you know?

Mr. KLECKNER. Senator, I frankly don't know.

Senator SARBANES. Now, I'm not clear on your responses as to why—is it your view that, if the regulation of stock index futures is done by the SEC, that somehow that will affect the cost that farmers experience in the commodity markets?

Mr. KLECKNER. Senator, yes, that's what we believe.

Senator SARBANES. Now, would you explain to me why that would be the case?

Mr. KLECKNER. Because you would be taking some volume away from the exchanges now and from the CFTC.

Senator SARBANES. Why would you be taking volume away from it?

Mr. KLECKNER. Well, there's—they currently handled this on CFTC. And——

Senator SARBANES. And what?

Mr. KLECKNER. Beg your pardon?

Senator SARBANES. Sorry. Go ahead. What happens?

Mr. KLECKNER. And they're paid for it, I believe. I would assume that, again, never having been there, you don't get anything done for nothing. So the CFTC now covers a broad range of these, agricultural as well as on the stocks. And by removing part of what they're doing now from their jurisdiction and moving it to SEC, you're removing part of their business.

Senator SARBANES. Removing part of whose business?

Mr. KLECKNER. CFTC's.

Senator SARBANES. Well, why does that affect the cost to the farmer?

Mr. KLECKNER. There's overhead involved in running any business, and so——

Senator SARBANES. Overhead on whose part? The trading companies?

Mr. KLECKNER. Well, far as I'm—CFTC has an overhead. The Chicago company, and certainly Mr. Mahlmann, some of the other people here, could answer this better than I, I'm just speaking from the overall point of view that they have costs involved——

Senator SARBANES. It's not going to affect the business of the Chicago companies because it will just have a different regulation. But it's not as though they're going to lose this business. It will be subjected to a different regulatory authority. The business will still be there, and the costs will be spread over that business, will it not?

Mr. KLECKNER. Well, maybe I haven't understood what the proposal is. I thought the proposal was to move it to the SEC.

Senator SARBANES. The regulation of it. The companies will continue to—the companies on these exchanges will continue to engage in this business.

Did you understand that?

Mr. KLECKNER. No.

Senator SARBANES. Well——

Mr. KLECKNER. Let me followup then with a question for you, Senator Sarbanes. You're saying that there would be no diminishing of the business for the CFTC.

Is that——

Senator **Sarbanes**. It's not the CFTC's business that affects your costs, as I undertand it. Your concern is the costs of the company. The CFTC is funded by appropriated funds, is it not?

Mr. **Kleckner**. I don't know how it's funded.

Senator **Sarbanes**. Well, I'm just trying to understand your point. You take the point that if the regulation is done by the SEC over stock futures rather than the CFTC, that somehow costs are going to arise to the farmers because, as I understood it, you said there would be less business and, therefore, the costs would be spread over a smaller base.

Is that correct?

Well, is that less business?

Mr. **Melamed**. Senator Sarbanes, could I?

Senator **Sarbanes**. No, I'm addressing Mr. Kleckner.

Mr. **Kleckner**. Senator, you're getting into this to an area that I am not familiar with.

Senator **Sarbanes**. No, this is a pretty simple area, Mr. Kleckner now. I mean, if you're going to make that assertion here in testimony, I have to have some sense that you understand the issue.

The fact that the SEC is going to do the regualtion will not affect the companies on these exchanges still doing that kind of business.

[Pause.]

Mr. **Kleckner**. Senator, we're talking here, in this proposal, on S. 2814, about a dual regulation. In the overall regulation then, you would be, in my opinion, diminishing the authority, perhaps the—not the respect, but the efforts, the thrust of the CFTC. They regulate in many areas now other than just agriculture.

We're talking about starting the movement with one. Correct? It's our opinion that you will have—that this is the beginning, that there will be other movements in the future away from CFTC regulation.

Senator **Sarbanes**. No, that's not the point I'm addressing. I'm addressing the very simple point that, as I understood your assertion and you've confirmed it in the course of this question, that somehow because the locus of the regulation would be changed, that it would affect the extent of business done by these companies on these exchanges and, therefore, boost the price to the farmer.

Now, for some reason, you seemed at least to have thought that they were going to be denied the opportunity to do that business.

I take it, that was the premise on which you were assuming these increased costs. Is that correct? That was certainly what you indicated in response to a previous line of questioning.

Mr. **Kleckner**. That was the least part of it, Senator. If that is——

Senator **Sarbanes**. But that's simply not the case.

Mr. **Kleckner**. If that is not the case, I guess the opposite would be then the assumption that there would be no increased costs to the exchanges whatsoever if this movement took place.

And I suspect that is not the truth or the case.

Senator **Sarbanes**. Well, but you are also basing it on a loss of business, too, I take it, from your previous answer.

Mr. **Kleckner**. That was my assumption. Perhaps I'm incorrect in that.

Senator **Sarbanes**. Well, I see my time is up, Mr. Chairman.

Senator DODD. Well, let me just to followup a little bit. You understand, Mr. Kleckner, that it has been stated about as unequivocally as anyone can, both from Secretary Brady and others, that there is no desire at all to get into the commodity futures issue at all, which is your primary concern.

With respect to my question to you earlier—that you really don't have an opinion on the question of jurisdiction over stock and stock index futures and the exclusivity rule—you really don't.

The Farm Bureau doesn't take a position on these issues. Your position is:

This is the nose of the camel under the tent.

Isn't that correct?

Mr. KLECKNER. Basically, that's right, Senator.

Senator DODD. So the letters that state your position here really don't address the question because the question is one that's really not on the table. And that question has to do with jurisdiction over physical commodities, which no one is suggesting changing. I totally oppose that. The CFTC should not lose jurisdiction over futures or physical commodities.

Nor should it be melded into some other agency. That's off the table. And that's your primary concern.

Mr. KLECKNER. Senator, true, it's off the table for now, but——

Senator DODD. Well, but that's all we're voting on here. No one is suggesting—I know of no one that has an amendment in this institution, although there's a bill in the House kicking around, that isn't going anywhere that would merge the CFTC and the SEC.

I'm flatly opposed to eliminating the CFTC. All we're dealing with here are these other issues.

Senator SARBANES. Did it ever occur to you, Mr. Kleckner, that the CFTC might be able to do a better job and commodities futures might work better if they weren't—if the financial futures were somehow handled differently?

Mr. KLECKNER. Senator, it never occurred to me one way or the other. I think the members here at the table could address that issue a lot better than I could. I could only guess.

Senator DODD. No, Mr. Kleckner, the point is being made that every feed and grain store and grange and small farmer in America is deeply interested in the question of stock index futures and stocks and the exclusivity rule. [Laughter.]

And that just isn't the case, is it?

Mr. KLECKNER. I don't know who——

Senator DODD. Well, Now do you know——

Mr. KLECKNER [continuing]. Said that.

Senator DODD [continuing]. How many farmers have called you? When was the last time there was a meeting of the Farm Bureau where they debated the exclusivity rule? [Laughter.]

Mr. KLECKNER. Senator, you're right, it's been a while. [Laughter.]

Mr. PETERSEN. Senator Dodd.

Senator DODD. And so you've got all of these letters flying around and they're going to stand up and create the illusion that every small farmer in America is deeply interested in this issue, and they're not, are they?

Mr. KLECKNER. No.

Mr. **Petersen**. Senator Dodd, may I respond, please?

Senator **Dodd**. Yes, we'll come back. Let us get a vote.

We'll recess for 5 minutes.

[Recess: 12:37 p.m. to 12:52 p.m.]

Senator **Dodd**. The committee will come to order.

I'll expect—I think Senator Heinz is returning, and I believe one or two other members. The problem is that we're trying to wrap it up here because we have our conference lunches today, and I don't want to ask you to stay around in the afternoon. I know you want to get back to your businesses.

Mr. Kleckner, first of all, thank you for your candor and honesty. I fully appreciate the point of view of the Farm Bureau. I think we all do up here. There's a very legitimate reason for you being here. This is a question involving the CFTC, which is a vitally important agency in terms of the issues affecting American farm interests.

And, obviously, when you start fooling around with jurisdictional questions with an agency that does have the primary responsibility of dealing with commodities in this country, then it's extremely important for the Farm Bureau and others to take a close examination of what that all means.

And the fact is there is legislation, pending in the House, sponsored by Congressman Glickman, which would effectively eliminate an independent CFTC and merge the two agencies.

That clearly could have implications.

So, when I say nose of the camel, it's the suggestion that there isn't any nose of any camel kicking around. There is a camel kicking around. And you would be derelict in your responsibilities if you were not here to express your concerns and the concerns of the American farming interests about that question.

You've made it very clear from the very beginning that the other matters affecting stocks and stock index futures is not an issue for the Farm Bureau other than to the extent that it involves the various agencies here that are being discussed and the jurisdictional question.

So I apologize if I was a little emphatic.

American farming interests getting involved in stocks and stock index futures is really not their primary concern, but the concern is whether or not this is going to spill over into the area of the commodities futures, which could have a profound effect on American farming interests.

And you're absolutely correct in that. So I thank you for your candor. It was very refreshing.

Mr. **Petersen**. Senator Dodd, could I follow up a bit on the cost of this bill, of S. 2814?

Senator **Dodd**. I'm sorry.

Mr. **Petersen**. Could I follow up a bit on the cost issue of this bill, S. 2814, where we ended up earlier?

Senator **Dodd**. Does it relate to this last point here? I'm just trying to move along.

Mr. **Petersen**. OK. That's all right.

Senator **Dodd**. Senator Heinz.

Senator **Heinz**. Mr. Chairman, I got more than I bargained for here. [Pause.]

INTERMARKET REGULATORY DECISIONMAKING

I want to ask our witnesses some questions about intermarket regulatory decisionmaking because, although there have been many different and sometimes conflicting conclusions drawn from the stock market crash of October, 1987, there was unanimous agreement that the stock, the stock options, stock index futures markets are, in fact, one economic market, although we've had testimony to the contrary here today.

There was also unanimous agreement that the inter-relationships among these market segments demand coordinated and consistent regulation.

And so, in the light of that reality, President Reagan established the Working Group, which Kash Mahlmann, Leo Melamed and I and other discussed back in 1987. It was thought to be a very positive undertaking. I think it has been in many respects positive.

Indeed, in testimony before this committee over 2 years ago, the CFTC and the futures exchanges strongly supported the formation of the Working Group. The Working Group, in its May 1988 interim report, told Congress that this group, and I quote:

> * * * provides a coordinating framework for consideration, resolution, recommendation and action"—with special emphasis on the words "resolution" and "action."—"on the complex issues raised by the market break in October 1987.

A few months ago, the four-member—and I referred to this earlier—the four members of the Working Group appeared before the Securities Subcommittee. We asked for their views on the three measures contained in the Capital Markets Competition Stability and Fairness Act.

Under Secretary Glauber, SEC Chairman Breeden and Federal Reserve Chairman Alan Greenspan testified that they supported Federal oversight of margins on stock index futures. CFTC Chairman Gramm disagreed.

Under Secretary Glauber, SEC Chairman Breeden, Chairman Greenspan testified that the exclusivity clause of the Commodity Exchange Act stifled innovation and competition of financial products and supported modification of it.

Chairman Gramm disagreed on behalf of the CFTC.

Under Secretary Glauber, Chairman Breeden, Chairman Greenspan testified that regulation of the stock index futures should be transferred to the SEC.

CFTC Chairman Gramm disagreed.

My question to the panel: Three of the four members of the Working Group support the administration's legislation. Should Congress follow the recommendations of a majority of the Working Group?

Kash, we haven't heard from you much today.

Mr. **Mahlmann**. I think we ought to, first of all, separate each one of the points, what every party said, and stipulate it.

I think, first of all, Chairman Greenspan—first of all, I endorse the Working Group. And their working together, out of that has come substantial improvement in coordination between the markets.

And as Leo testified a little while ago, out of the stock exchange panel came recommended circuit breakers, both the Board of Trade and the Mercantile have submitted those for rule approval to the CFTC. And I think it should be now the Working Group's function to adopt those also on the security-related, SEC-regulated markets.

We have taken the step that we have it coordinated. The Wall Street Journal says this morning:

Those coordinated steps, called circuit breakers here, do work and they passed their test.

Cooperation, I submit to the Senator, has worked and would work better if we quit this squabbling of interagency warfare. I think we can have a lot more progress made if this squabbling stops that has occurred over the past whatever number of months.

Senator **Heinz**. Well, I don't think you'll find anybody to disagree that we would like the interagency—what you describe as squabbling—to disappear or to be resolved. But it takes resolution of the disputes, because what you describe as squabbling is to each side, presumably, a legitimate dispute.

And I guess just to return to my question and then I'll come back to your point in more detail, when you and the MERC testified in support of the Working Group more than 2 years ago, was the thought that only recommendations supported by all four members of the Working Group should be implemented.

Was that the idea from the beginning?

Mr. **Mahlmann**. I think we have very much lived up to that concept of the Working Group's recommendation to implement at our exchanges.

But, if I have permission to come back for 1 minute to the margin question of Chairman Greenspan.

Chairman Greenspan says on one side—he enumerated four points. That the margins set by the exchanges are fine for prudential purposes and settlement and clearing systems.

He then also enumerated that raising margin levels above those prudential levels will incur a decrease in liquidity in the marketplace.

And his concern was that, when futures exchanges raised during a time of stress margins on top of the stress, that it could lead to a stretching of the rubber band in the credit system.

So, he advocated that somewhat higher margins would probably be—should be applicable.

I think the two futures exchanges have reacted to Mr. Greenspan's statement. We have somewhat higher margins. We have them above the prudential level, so that as not to stretch the rubber band in a 100-point Dow break, as occurred yesterday. There had to be no margin increase.

EXCHANGES SHOULD BE THE PRIMARY MARGIN SETTERS

Chairman Greenspan also testified that the exchanges should be the primary margin setters. And that they have proven to a valid job. And it is also substantiated in the House Subcommittee under Steve Neal in the report that committee wrote.

So, if the exchanges have the primary function, then I submit to you, any Federal agency, whether it's the Fed, the CFTC or the SEC, would be in the secondary role.

We can't have it both ways, that we have oversight on one and the exchanges have primary functions. It's got to be one or the other.

And I think every ounce of evidence that this committee or any other committee has heard, that the margin-setting policy of the exchanges have been prudential, prudent and not jeopardized any system in this country.

Senator **Heinz**. Well, my problem is—I am perfectly prepared to get into a discuss in of margins, but I didn't ask you the question about margins. I was trying to ask a question about—and I'd like to try and stick to the question, if we could, because there's a time problem here—about the issue of coordination of Working Group decisions, particularly the intermarket issues, which are of great concern to—I trust—everybody.

I want to come back to something you said on page 22 of your testimony, Kash, where you said that:

> If we need coordinated circuit breakers, better CFTC-SEC cooperation to deal with innermarket front running and faster, more efficient clearing and settlement systems, you suggest that we do it now.

It's been more than 2½ years since the 1987 market crash. Why hasn't it been done up until now?

Mr. **Mahlmann**. Senator, I submit the futures exchanges have extremely well-cooperated with the Working Group throughout this.

Senator **Heinz**. That's all very well. But, these are specific things: Coordinated circuit breakers. All right? They are not coordinated today.

Intermarket front-running, cooperation on that.

So far as I know, that hasn't happened.

Faster, more efficient clearing and settlement systems. As far as I know, there is not a system that takes into account people's ability to cross-margin. So when people have margin calls being met in Chicago, you have liquidity being drained in New York.

I mean, one of the big issues, it seems to me, is how we are going to get this coordination. I don't know of anybody who thinks that having disconnects between the two markets is a good idea. Everybody has said—if somebody thinks it's good to have the disconnects between the two markets, speak now or forever hold your piece.

But, the question is: Since there are certain issues that everybody thinks ought to be dealt with from your side as well as all the other sides—and we are not dealing with them—what are we going to do about it.

ONE REGULATOR

So, let me ask you this. We've got some options. You know, one way, and it's the way it's proposed in the administration bill is to have a single regulator.

Now, that's one way to do it. You're saying, oh, there are all kinds of problems with that. Now, if we don't adopt that approach to getting the job done, how do you suggest that the disagreements among the regulators be resolved rather than just having endless, continuous disagreements?

Let me ask Mr. Wilmouth, Mr. Seale, Mr. Petersen, Mr. Lane, Mr. Kleckner—I'd like you first to answer that question.

If you have an answer?

Mr. WILMOUTH. Yes, I do.

Senator HEINZ. Well, what's the answer.

Mr. WILMOUTH. Well, I think, first of all, that we have to understand that there has been no real detailed study done as to what problems, if any, really exist. I'm not——

Senator HEINZ. I'm sorry, Mr. Wilmouth. I can't accept your contention. We've got detailed studies this high.

Mr. WILMOUTH. All right. I——

Senator HEINZ. More importantly, both Mr. Melamed and Mr. Mahlmann have testified on previous occasion before this committee that there are problems. So, don't say that they're wrong.

Mr. WILMOUTH. There are problems—I'm not saying that they're wrong. I'm saying there are problems, but I'm not certain we have examined all of the possible solutions to those problems.

I think, to a certain extent, I'm saying the same thing that you have. My concern——

Senator HEINZ. Well, we're asking you for alternative solutions. That's my question, not whether they're wrong, but are there alternatives to having the SEC regulate financial futures as well as stocks.

That's my question.

Mr. WILMOUTH. I think there are a number of alternatives. And what I'm trying to say is I thing they should be studied more carefully.

Can I list some of them? No. 1——

Senator HEINZ. So, your answer is: Let's keep studying?

Mr. WILMOUTH. No. And it's not keep——

Senator HEINZ. Well, then what's the answer?

I'm looking for specifics, not for the answer, let's keep looking. Let's keep studying. Let's procrastinate. We're good at that here, I admit. It's tempting to agree with you, but that's not what I'm asking.

Mr. WILMOUTH. If we are fully aware of and believe we know all of the problems that exist—and I think we know many of them. I'm not certain we know all of them—then we should look at a system to look at the entire financial markets, which could end up, if you want a specific solution, in something pretty close to what Senator Dodd has referred to, the Glickman bill. That is one way. That is one solution.

And, right now, although I haven't looked at all of the problems, from what I see, that's the best solution that I would have to offer right now. It's something along those lines—not two cops on the same beat, but one cop.

You made reference, for example, to the SIB and to the Association of Futures Brokers Dealers and The Securities Association in London and what they're doing.

My understanding of that is they have at the top the SIB, which is an umbrella regulator. Underneath that umbrella regulator are five other entities—AFBD and TSA. Others for the insurance industry, and so forth and so on.

One of the things they're attempting to do, because futures people are now allowed to pick whichever of the two they want to join—AFBD or TSA—to have them all join one entity, so that the AFBD would take care of all the futures people; TSA, all of the securities people.

That's a solution that I think we could look at. In other words, one entity at the top to look at everything and to oversee everything, with a futures division——

Senator HEINZ. Let me ask Mr. Seale, Mr. Petersen—thank you. That's very helpful.

Mr. Seale.

Mr. SEALE. Senator, my preference would be for two regulators, CFTC, SEC and negotiate out the differences in the——

Senator HEINZ. Well, that's what we're doing now.

Mr. SEALE [continuing]. Negotiate the differences in the Working Group and in the exchange, direct exchange negotiations between each other, the securities and futures exchange,

Senator HEINZ. Well, that's very nice, but that's what we've been doing for the last 2 years. How is that different?

Mr. SEALE. I don't think it is different, Senator. What I'm saying——

Senator HEINZ. All right. So you don't have——

Mr. SEALE. What I'm saying, I'm supporting the status quo, where we are now.

Senator HEINZ. OK. The status quo. Even if the status quo isn't working, you're for it?

Mr. SEALE. I'm not sure it's not working, Senator. You think it's not working. I think it's working.

Senator HEINZ. Well, it hasn't achieved any of the things that the members, including the people you are sitting at the table with, said needed to be achieved.

Mr. SEALE. Senator, some of the things that were in the Brady Report of 1987 have been achieved. They have been done. There are a lot of changes that have been made since that time.

Senator HEINZ. But I picked out three, very specific, important things. I told everybody what they were. OK?

You're entitled to your own opinion, but you're not entitled to your own separate set of facts.

Mr. SEALE. Senator, it is a fact that a number of things in the 1987 report by the Brady Commission have been implemented. Other of the recommendations may not have been.

Senator HEINZ. Look, let's not quibble. I'm talking about——

Mr. SEALE. I'm not quibbling, Senator.

Senator HEINZ. I'm talking about coordinated circuit breakers, dealing with intermarket frontrunning and more efficient clearance and settlement systems.

What have we done in those areas?

Mr. SEALE. Senator, I don't know specific details. I'm not with——

Senator HEINZ. All right, then, if you don't know, then don't pretend you're an expert. You know?

We're supposed to have informed testimony before committees of Congress.

Mr. **Seale**. Senator, my comment was regarding the question of what my preference was, was the way I understand the question. What my preference was and my Association's preference as to whether there would be one regulator, two regulators, some combination of regulators.

Senator **Heinz**. That's right. You answered the questions, but then you went on to say there was a lot of things that had been solved. There was no problem.

Mr. **Seale**. That's correct, Senator, they have been solved. That is fact.

Senator **Heinz**. Well, sir, I suggest you take a look at the record of the people who are at this table with you.

Mr. Petersen.

Mr. **Petersen**. Thank you, Senator * * * I think. [Laughter.]

We—I join Mr. Wilmouth in saying that, fundamentally, we would support a broad study of the issues involved. In other words, looking not only at regulation of futures, but also the stock market, the stock options market, banking, insurance, the entire financial marketplace, that may be the best broad overview as far as to evaluate this.

I would also add that we are very comfortable and support the present system of functional regulation. We feel that that's appropriate.

On the issue of what you do when you have a dispute among the Working Group, I'm not sure there's an easy answer. I would suggest that I think the President has it within his power to call the chairman or the two chairmen together in his office and say: "The present system stays. Now, you folks work it out or make it work."

Just some observations.

Senator **Heinz**. You talk about functional regulation. If we're really for functional regulation, why doesn't that argue for having both stocks and derivative products under the same regulator?

Mr. **Petersen**. I think it argues exactly the opposite.

Senator **Heinz**. Well, what's the function?

Mr. **Petersen**. The functional regulation means that——

Senator **Heinz**. What function are we talking about?

Mr. **Petersen**. We're talking about the regulation of futures. And that is where we have developed a system where all futures are regulated by a single agency rather than having different futures markets or contracts regulated by the same agency which regulates the underlying cash markets. I don't think anybody wants to see that kind of fragmentation.

Senator **Heinz**. Wait a minute. We're talking function. OK?

Mr. **Petersen**. Yes.

Senator **Heinz**. You talking about functions called futures?

Mr. **Petersen**. Yes.

Senator **Heinz**. I call futures a product. OK?

Mr. **Petersen**. OK.

Senator **Heinz**. Function, it seems to me, is, in the case, could be in the case of what we're talking about, the ability of corporations to raise equity capital.

Now, I thought that the whole purpose of stocks and stock options and stock futures was to create a financial market where corporations could buy and sell, and investors could buy and sell equity capital.

Now, that's the function of that market.

Suddenly, I hear that: No, no, the function of that market is to have individual products traded individually regulated by a specific regulator.

The function that we're talking about is a function where people put up money, accept varying degrees of risk, get varying degrees of return—not as traders, but as investors. At least, that's what I thought the purpose was.

Mr. PETERSEN. If I could mention from an agricultural perspective, and I think this would apply to stock index futures as well:

Futures reflect the cash market. They reflect expectations about the cash market. They reflect attitudes about the cash market. But, the cash market is the cash market. And people use futures to hedge their risk that they may have in the cash market.

So, there certainly is a difference, I think, in the purposes between the two marketplaces.

Senator HEINZ. Well, yes, there's a difference in the specifics of how they operate. But, I must say, listening to you, I'm unclear, quite frankly, as to why that's a different function.

Let me just, if the chairman will permit me to ask my question this way:

We got some options. We're dealing with them. Not stock options—alternatives. One is the one that you all don't like, which is having the SEC regulate futures. But, another option is to have Congress codify the Working Group and impose a majority rule on the members. A third is we just merge the SEC and the CFTC and then we wouldn't have to bother Mr. Petersen, the President, every time there's a dispute in the middle of the night between Wendy Gramm and Richard Breeden.

Apparently, he would have plenty of things to referee.

Or, we can go the current system, which is to have the courts and Congress have to resolve each dispute as it arises.

Assuming the status quo is not acceptable, what's your second choice? Kash or Leo?

Mr. MAHLMANN. Senator, I would like to first address—you starting with three points—that we testified to you before and——

Senator HEINZ. Well, I don't have the time to go and debate those three points. Please.

Mr. MAHLMANN. There's a number of those points that have been established. I just——

Senator HEINZ. Fine.

Mr. MAHLMANN [continuing]. Wanted to put that on the record.

Senator HEINZ. By all means, put it on the record. But, do it, if you wouldn't mind, later, please. [Laughter.]

Mr. MAHLMANN. I think I would support either choice of the following:

No. 1, this committee and Congress can tell the agencies to quit the regulatory imperialistic war that's been going on for a year which really has, in a way, stifled the coordination of the Working Group because of this going on.

If Congress puts it to bed, it has that choice to do so and tell the agencies to get on with business.

The alternative, if Congress really wants to look at the international—national and international—financial market, it would have to incorporate international regulation, that there is a level playing field. It would have to incorporate banking, S&L's, insurance companies, on exchange/off exchange products.

Senator HEINZ. Do you mean solve every other problem——

Mr. MAHLMANN. No, Senator.

Senator HEINZ [continuing]. First?

Mr. MAHLMANN. All of these entities are in the business of derivatives or futures contracts or contracts calling for future delivery, all of them interlock.

Senator HEINZ. Kash, give me a very specific example so I really understand what you're talking about.

Mr. MAHLMANN. So, if you wanted to start with the House bill, you should need to broaden it to look at the whole thing.

Senator HEINZ. Yes, but give me one example of something that you think has somehow escaped the net here.

Mr. MAHLMANN. OK. We have just got an issue of a grant forward oil contract that is being exempted.

Senator HEINZ. Right. They're being done in London, a lot of them. Right?

Mr. MAHLMANN. It is being exempted from its qualifications, same as IPS, that is is a futures contract.

Senator HEINZ. Um-hum.

Mr. MAHLMANN. It can be exempted under various avenues, that is a foreign delivery instrument.

Senator HEINZ. Yes.

Mr. MAHLMANN. But, if we are going to address the financial system and the interlocking relationships——

Senator HEINZ. But, what? Is there something wrong with the fact that it's unregulated * * * at times?

Mr. MAHLMANN. OK. We have to ask ourselves that philosophically: Are we pushing markets into unregulated environments? And do we want markets, American customers, to participate in unregulated, no capital requirement, no safeguards in those instruments?

Is that what we want?

Then, let's open it all up.

Senator HEINZ. Well, that's exactly why I'm asking you.

Leo, did you have a comment?

Mr. MELAMED. Well, I certainly would not prefer a nonregulated environment for some of these important products.

Mr. Heinz, we just saw what happened to the savings and loan industry in a rather unregulated environment. And I wouldn't want that to happen with any of the futures market product lines or potential market product lines.

I would rather they fall one way or another.

I agree with you, there can be exceptions. But, in some instances, we're talking at such a narrow product line, that, really there has to be just simply a way of defining them.

Senator HEINZ. I want to correct something you said, Leo, at least—and this is a matter of judgment, I recognize. But, you said that the S&L's were unregulated.

In fact, contrary to anything Phil Gramm or anybody else says, there were three regulators of the State regulated S&L's.

First, there were the State regulators. They didn't regulate. They just ignored the problems.

Second, there was the FSLIC. It no longer exists. We put it out of business. They didn't do a very good job.

The there was also, the Federal Home Loan Bank Board. It tried to regulate. Congress wouldn't give them the money. And the so-called regulatory money ended up in the hands of the regional Federal Home Loan Banks.

What you have there in the S&L debacle is a very good example of the failure to have strong, consistent, across-the-board regulation. You know, that's what we're trying to get here.

And my concern is that if the S&L disaster was a $130–150 billion disaster, and you compare that to October 19, 1987, which was a $1 trillion disaster—it wasn't maybe to traders, but it was to investors. The fact is that, you know, we've had two big drops—in October 1987, 1989—they are hurtful to the capital markets. They are hurtful to you in Chicago. You volume is below what it was in 1987. It seems to me that, if we're inviting another S&L problem, it is in our failure to achieve some consistency and harmony in regulation.

Mr. MELAMED. Are you asking a question, Senator?

Senator HEINZ. No, not really. But, you can react.

Mr. MELAMED. I didn't think so. Pardon me?

Senator HEINZ. You brought up S&L's.

Mr. MELAMED. I brought up simply that, in my view, the regulations over S&L's were not sufficient. And perhaps I'm wrong, but I think that there's something wrong with what happened. I do believe that the regulations in securities and futures markets are very well-coordinated and are acted upon by two very competent agencies.

And I don't believe that there is any resemblance between the S&L and the futures industry, or anything like that.

As a matter of fact, with respect to the three points that you brought up, which is circuit breakers, intermarket front running, as well as settlement and clearing, may I try to answer those three specifically?

Because in circuit breakers, both the stock exchanges and the futures industry did get together on circuit breakers and they do have them in place, and they work very well.

What I was talking about is the recent NYSE Blue Ribbon Panel recommendation for some modifications that the futures industry has already acted upon. But, circuit breakers are in place and they are agreed on by the New York Stock Exchange. That came out of the working party.

Similarly, intermarket front running was agreed to between the New York Stock Exchange and the Chicago Mercantile Exchange. It's in place today. That, too, was a recommendation from the Presidential Working Group.

The only place where we really didn't get together, where the futures markets could get together and did, and that was in settlement and clearance procedure.

The futures side literally implemented everything that the Brady Commission recommended. We could not get together with the securities side because they have 5-day settlement, we have 1-day settlement. And until they move their settlement procedure to a 1-day format, we can't do anything about it.

So, indeed, we did everything that was reasonable that we could do and did get together with the securities side as the Working Group recommended.

And that's the record, Senator.

Senator HEINZ. Oh. Well, thank you very much. [Laughter.]

Senator DODD. Thank you, Senator Heinz.

HOW EXCHANGES DETERMINE MARGINS

Just a couple of questions, if I could. I started out, Leo, talking about the differences between margins. And, really, sort of a threshold question, I guess, for a lot of people is:

How are margins determined by the exchanges?

We've seen them jump around a little bit. Just for the purpose of the record, S&P 500 futures contracts initial hedge margins were 3.3 percent of the contract value on October 15, 1987. They jumped to 12.26 percent on October 29 of that same year. They moved a little higher than 8 percent on January 12, 1988. And then to 2.9 percent in September 1988.

So, if you look at the stretch in there, you'll see a lot of movement on the hedge margins.

In May 1989, hedge margins were 2.6 percent. Now they're up, as I mentioned at the outset, I think at 4.39 percent or 4.445 percent, somewhere in that range.

What I would like to know, is how is that determined? What affects it? You're heard the anecdotes. I'm not telling you what you haven't heard, anytime there's a problem, there's a congressional hearing. There's an action like yesterday, you see movement on the margins based on factors that are more political in nature rather than on some economic concerns.

That's what you hear. But, what I would like to hear from you is how they are determined. What factors go into that? Why such movement?

Mr. MELAMED. Senator Dodd, the essence of margins in futures, which someone characterized—I think it was Senator Gramm—that they's better defined as performance bonds, or earnest money—is based on prudentiality. Their purpose is to secure the system from failure of anyone of its members not having enough money in terms of the movement of prices that can be expected.

Price volatility is what guards us and guides us. And, indeed, we do change the margins quite often as a consequence of that volatility.

When the volatility, the interday market deviation that we look at, is small, the margins can afford to be lower. When the interday volatility is larger, or the expectancy of price movement is larger, our margins rise with that particular need.

And that has been the case. That is really a very good testimonial for why the only ones that know precisely how to do that, and can do that on a day-to-day basis as is required, are the futures exchanges themselves.

We have changed securities margin something like 12 times in the last 2 years. I know the Board of Trade on all its margins goes through numerous changes during the course of the year, as we do on Euro dollars or currency, and so forth, and agriculture.

And the reason is always price volatility, price movement, expectancy to guard the financial prudentiality.

That's the main reason.

Now, we have been politicized. And political processes force us to react sometimes differently than we like. But the prudential reason is still the main reason why margins ought to be what they are.

Senator **Dodd**. As a practical matter, Leo, and excuse the naivete of the question, but how does it practically work? Who actually does the setting?

Mr. **Melamed**. There's a margin committee that can act in emergency immediately. If it's not an emergency situation, they will make a recommendation to the Board of Governors. The Board of Governors almost always approves the margin committee's recommendations.

Senator **Dodd**. Let me thank you for that.

We talked about the question of how much coordination there is between the two exchanges, and I appreciate your response to Senator Heinz' question.

I would just share with you here the experience, and this isn't my personal experience, but the staff's experience.

In trying to sit down with the staffs of the two agencies and just having gone through, as they have, lengthy meetings, trying to agree on just common data on margins—forget the question of trying to arrive at some sort of conclusions which they can both live with—we have gone through the terrible frustration of literally having people just pack up their bags and walk out of the room, never getting to some of the questions of how you might come to common ground—or to any kind of agreement on what the data is, or what the facts are we are dealing with here.

So I raise that for you because you should know it.

We do find this very frustrating in dealing with the two agencies to get the kind of cooperation that you obviously want to have.

You've obviously achieved some cooperation. I think it's important to commend the exchanges for what they did in the wake of the market breaks. A lot of progress has been made because of the leadership.

And there still are some questions, obviously, that need to be addressed or we wouldn't be here.

TRANSFERRAL OF MARGIN-SETTING POWER

There have been some suggestions. I've raised it here myself in the past and other have brought it up Leo, would you say any transferral of margin-setting power would be harmful? What about the idea of giving it to some agency like the Fed, which has been the common suggestion that's been offered?

Is that absolutely out of the question?

I realize what the perference is. But, we're looking for a possible solution that could help us get beyond this point, that would not be harmful to you and yet would allow us to move forward and take care of some of the concerns—although I realize there's a debate over just how legitmate those concern are. So, I'm not talking about the ideal world. But, is there room here? As someone who is caught in the middle of this, I'm envisioning what will happen when we get to the floor of the Senate or the House on this issue and we end up having a huge battle over this issue. And I'm not sure we ought to get into that necessarily—if there is a way of resolving some of these question. What do you suggest?

Mr. **MELAMED**. Well, Senator, I, too, would like to resolve some of these questions so I'm with you 100 percent in terms of trying to find a resolution.

We are here today to merely tell you that, as far as jurisdiction goes, we simply would reject that idea. And as far as some of the other issues are, we clearly believe and have shown and demonstrated that the exchanges ought to be the front line of decisionmaking in terms of margin.

When you asked me about the Federal Reserve, I hold the Federal Reserve in great regard. I believe that it is one of the best agencies in terms of understanding the function of our market. And, certainly, you know, asking me at this moment in time to pick and choose, I can't possibly do that.

But I think I have answered your question in terms of some of these thoughts.

Senator **DODD**. Do any of you here want to make a comment on this?

And, by the way, Mr. Petersen, I want to give you a chance to come back because you did want to comment about another matter.

Mr. **PETERSEN**. Well, I was interested in the costs——

Senator **DODD**. Well, let me get to this one first. Then I'll come back to that last.

Yes, Mr. Mahlmann.

Mr. **MAHLMANN**. Mr. Chairman, I would like to quote again from my testimony. And I think, you know, this arises from a House Subcommittee, and I'll just quote from the committee's report. This is the major concern that we have as a Board of Trade, or I think Leo and I jointly have, or all futures exchanges have.

> Any Federal agency directed to set futures margins would be driven by the nature of the incentive it faces to set margins higher than needed to protect financial integrity, thereby imposing excessive costs on futures markets traders, contract market liquidity and impairing market efficiency. Imposing substantial costs on traders through higher margins would drive the larger hedges to seek other outlets for risk transfers. Most will eventually turn to foreign futures markets. No public purpose could possibly be served by driving the large institutional users of our own well-established market into foreign hands.

And I submit that should be a guiding light to this committee also.

Senator **DODD**. All right, anyone else want to comment on this point?

Mr. **PETERSEN**. On margins?

Senator **DODD**. Yes, just on that point.

Mr. **Petersen**. I would just say, Mr. Chairman, that margins or the idea of transferring margins to a Federal agency is certainly not new for agriculture. Over the last 40 years, it must have come up at least 10 times. And the National Grain Trade Council has historically opposed such a change. We feel exchanges are in the best position to set margins; they have the best expertise and we believe their track record is very good.

Senator **Dodd**. OK. Very good.

I think we've covered the waterfront today. Do you want to go back to that earlier question.

Mr. **Petersen**. Well, I was going to clarify for the record, as far as Mr. Sarbanes' questions of Mr. Kleckner, and point out there are definitely costs associated with two agencies regulating the same entities.

And as companies comply with dual regulation—they would have one agency regulating one portion of their business and a different agency regulating another portion of their business. Those costs are inevitably passed on.

There are futures trading professionals in rural America who provide services to agriculture. Some of those small businesses may be only marginally profitable. And for some of them, this additional recordkeeping or additional personnel requirements may well not be worth the cost. Or, if it is, they will increase their charges to recoup these increased costs.

For our members, who are largely commercial grain companies, if these increased costs affect them, what happens is you have a widening of the bid-ask spread. Very basically, that means that grain companies are able to pay farmers less and they have to charge their foreign customer or the ultimate user more.

Senator **Dodd**. OK. All right. Well, again, I want to thank you all for coming. There may be some additional questions that members will want to submit for the record and I ask that you respond to those when they are forthcoming.

Again, Leo, it's a special pleasure to have you here.

Mr. **Melamed**. Well, Senator, I want to thank you, especially for your kind comments and for your efforts in this respect because I watched them on C-Span and enjoyed the committee and its work. And you've done an excellent job.

Thank you.

Senator **Dodd**. Thank you, Leo, very much.

And thank all of you.

This committee stands adjourned until the further call of the Chair.

[Whereupon, at 1:34 p.m., the committee adjourned, to reconvene, subject to the call of the chair.]

TESTIMONY OF PAUL TUDOR JONES, II
SUBMITTED FOR THE RECORD
SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS
JULY 24, 1990

Mr. Chairman and Members of the Committee, I am the founder and chairman of the Tudor Investment Corporation. Tudor is a money management organization based in New York which participates throughout the world in a wide range of financial and commodity markets, with a special emphasis on futures trading.

I wish to thank the Committee for including this testimony in the Record. The recent proposals to modify the regulatory structure of United States financial markets are of enormous importance not simply to those of us in the industry, but also to all Americans.

It is, I believe, widely accepted that futures markets are an essential element of a healthy American economy. Historically, these markets have enabled commodity producers and commercial users to achieve greater price stability and predictability by means of hedging.

Currently financial futures markets provide an important level of protection to individuals and institutions who buy and hold financial instruments, including equities and Treasury securities. The breadth and depth of our futures markets enhance the strength and stability of our economy. In theory and in fact, capital formation in the United States and in all modern economies is promoted by the price-risk transfer characteristics of futures markets.

In order for the United States futures industry to fulfill effectively its key role in the economy, the following conditions must exist:

First, market participants must be assured that the prices they receive when placing their orders are the most advantageous possible. Trading violations and abuses must not and cannot be tolerated.

Second, markets must be orderly, and daily volatility must not be excessive. Episodes of excessive volatility threaten investor confidence in the pricing function of the markets. Furthermore, extremes of volatility could prove disruptive to the capital formation process.

Third, the regulatory environment must be clearly defined, and administered by those who best understand the markets. This is essential to establish and maintain the level of trading participation necessary for a futures market to succeed. Regulatory uncertainty and confusion must be minimized.

As a major participant in this industry, Tudor has a significant stake in assuring that the above conditions exist. I would like to make a brief comment on each.

As to trading abuses, effective enforcement of the commodities laws is critically important and should be given top priority. Tudor supports all reasonable steps to maintain the integrity of the markets. One particular step that we would advocate is that every futures pit should have at least one CFTC official on location monitoring trading activity at all times.

With respect to the problem of excessive volatility in the stock market, we would encourage the examination of such measures as the imposition of an immovable daily price limit for stock index futures and options on broad-based stock indexes. We believe the significant price decline in the Nikkei Index of more than 30%, from an index value of about 39,000 to one of about 28,000, occurred in a more orderly fashion than the comparable decline in our stock market which occurred in October 1987.

This was largely the result of an immovable daily price limit of 3 percent on the amount which stock index futures and options could decline in price. A market will ultimately move to the level determined by supply and demand. However, effective circuit breakers, such as price limits, can smooth the path to that new level.

With regard to proposals relating to the transfer of jurisdiction over stock index futures from the CFTC to the SEC, we have substantial reservations about such a course of action at the present time. Such a step could impose on most participants in the futures industry - brokers, money managers and the markets themselves - a costly, complex and unnecessary second layer of regulation. The resulting confusion is likely to dramatically reduce participation in the stock index futures markets. Trading volume will decline and the attractiveness of the United States equity markets to global investors will be diminished.

In fact, for firms such as Tudor which manage large pools of money in the futures markets and contribute to their liquidity, participation in these markets may be precluded by the treatment of stock index futures as securities. This will result in business activities or entire businesses moving offshore, which is surely an undesirable result. Either outcome decreases the ability of firms to raise capital in the United States.

With this in mind, the hasty reordering of jurisdictional authority would be ill-advised. Simply changing the organizational chart will not resolve concerns relating to volatility and trading abuses. These are problems that should be tackled directly.

I am not suggesting that we would not benefit substantially from a thoughtful reevaluation of the relationship between all of our financial markets and the regulations that presently exist. It may well be that such a study would demonstrate the need for a reorganization of some kind. It is highly unlikely, however, that it would lead us to move just a few pieces around the board. If a "super-agency" is ultimately seen to be the best solution, then the "piecemeal" strategy of transferring stock index futures jurisdiction to the SEC is inadvisable at this time.

The existing regulatory structure has fostered the most innovative and progressive derivative products markets in the world, and we should take care not to surrender the competitive advantage our industry enjoys as a result of precipitous shifts in jurisdiction.

Once more, I would like to thank the Chairman and all the Members of this Committee for permitting me to participate today in this debate. On behalf of my entire organization, I offer you any assistance we may be able to provide as you continue to examine the complex and critical issues which contfront our markets.

REMARKS BEFORE THE
62ND ANNUAL MID-WINTER MEETING OF THE
NEW YORK STATE BANKERS ASSOCIATION
THURSDAY, JANUARY 25, 1990

BY E. GERALD CORRIGAN, PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK

Good afternoon ladies and gentlemen; it's always a pleasure to have this opportunity to address the mid-winter meeting of the New York State Bankers' Association. Allow me to say at the outset that I find it hard to believe that this will represent the sixth year in which I will have addressed this group in my capacity as president of the Federal Reserve Bank of New York.

In that setting, I am reminded of the well known Chinese curse: "May you live in interesting times." However, I'm inclined to the view "interesting," yes, but not too interesting!! I say that because in reflecting on developments in banking and finance during the '80s I am truly struck with all that we have been through in ten short years.

In the early weeks of 1980 we saw the House and Senate reach essential agreement on the Monetary Control Act of 1980 which, among other things, was to usher in a whole new era of banking by virtue of its deposit interest rate deregulation provisions. But, in precisely that same time frame we also were confronted with the first of the major financial disruptions of the decade: the silver market episode. Little did we know at the time that the decade as a whole would see a recurring pattern of serious financial disruptions that would criss-cross financial markets and institutions of all types and sizes. LDCs, LBOs, big banks, small banks, thrifts, government securities dealers, stock markets, junk bond markets, -- to mention some -- have each, at one time or another, been sources of concern.

Perhaps because of good fortune, perhaps because of good policies, perhaps because of the ability of individuals and institutions -- public and private -- to rise to the occasion, or perhaps for all of these reasons, the economy and the financial system weathered these storms in remarkably good order. That is reassuring but it should not delude us into the belief that our problems are in any way behind us. Let me cite a few examples of what I mean:

-- Looking at money center banks, one cannot help but be impressed with the fact that over the last decade, the primary capital of these institutions has almost quadrupled in absolute terms and has more than doubled in relation to assets. That's the good news; the bad news is that for these same banks, net charge-offs over the decade have exceeded net income and at year-end 1989 -- after the longest peacetime expansion in history -- non-performing loans are more than double their level at the end of 1982 when the economy was coming out of the deepest recession since the 1930s.

-- the LDC debt situation -- while not nearly the threat to the international banking system that it was in 1982 -- still constitutes a major overhang on bank balance sheets and on the global trading and economic system. Indeed, for both the banks and the individual LDCs the problem today may, in some ways, be almost as difficult as it was in the early 1980s. The major banks, for example, have strengthened reserve positions to the point that makes it very inviting to simply walk away from the problem and the process, even though in the aggregate that very act could only mean that reserves would become charge-offs and then some. By the same token, the current environment for the LDCs is one in which the temptation to try to finance a country by accumulating interest arrearages or by otherwise ignoring or downplaying the need for ongoing relationships with private sources of credit flows might be very inviting, but not in the best long-run interests of the countries themselves. Indeed, either could drive a still larger wedge between the country and the ability to meet ongoing needs for external financing from private markets and institutions in a setting in which public institutions surely will not be able to do the job alone.

-- despite all of the earlier experience with concentrations of bank credit in REITs, in LDCs, in the oil patch and in agriculture, we still see large concentrations of lending in such areas as real estate and highly leveraged financings, either of which can be especially vulnerable to changing economic or financial conditions.

-- in securities and wholesale banking markets we see enormous pressures on spreads and margins amid recurring bursts of volatility, in a setting which seems to suggest an even greater preoccupation not just with the short run, but with the very short run. Indeed, I sometimes get the feeling that some market participants seem to view a long-term investment as one they hold overnight!! Unfortunately, I also have an uneasy feeling that the lessons that should have been learned from earlier bouts with adversity may not have been fully retained. For example, market participants still seem to me to suffer from the so-called "illusion of liquidity", whereby positions are taken and strategies devised in the belief that markets will always be sufficiently liquid to permit such positions to be unwound or hedged with relative ease and at little risk of loss.

In this environment the need for very strong internal controls, risk management systems, and tight managerial oversight becomes all the more compelling, even though such efforts are very expensive.

-- to cite just one more example, despite the passage of several important banking laws over the decade, the basic structure of our banking and financial system remains outdated and in disarray. In certain respects -- especially in an international setting -- I would go so far as to say that the structural flaws in the U.S. banking and financial system have actually gotten more serious if only because we tinker while others progress.

I could go on to cite other examples but I think the message is clear and that, of course, is that while the economy and the financial system of the '80s showed great progress and adaptability, we start the new decade with a major agenda of unfinished business. The most important part of that agenda has to do with macro-economic, structural and trade policies. Having spoken on those issues in another address only two weeks ago, I would like to concentrate the balance of my remarks today on some of the key priorities for the period ahead in the areas of banking and finance, with emphasis on a number of issues that strike me as having particular importance over the near to intermediate term.

A very high priority, at least as I see it, remains the need to reform and modernize the basic structure of our financial system. While it may sound presumptuous, I still regard the framework suggested in my 1987 essay, Financial Market Structure -- A Longer View, which was first introduced before this audience, as a very useful starting point in that effort. Having said that, I don't want to leave the impression that there may not be some specific areas in which events of the past three years may have shaded my thinking in one direction or another. However, on the most basic concepts -- including the case for a strong and independent banking system -- the depth of my convictions has, if anything, increased. I also recognize that reform and modernization of the structure of the Federal regulatory and supervisory system is long overdue, but I continue to believe that effort must follow, not precede, reform of the financial system itself. Finally, I continue to believe that whatever form regulatory restructuring might take, it is vitally important that the Federal Reserve, as the nation's central bank, retain a central role in the banking and financial market oversight and supervisory process.

A second area of importance relates more specifically to securities institutions and markets. Here I want to indicate my support for the broad thrust of S-648. The major provisions of that bill would provide for (1) authority for the S.E.C. to close markets in emergencies; (2) authorize the S.E.C. to collect information on large securities trades; (3) authorize the S.E.C. to collect information on the risk exposure of affiliates of securities firms, and (4) provide greater impetus for coordination of clearing and settlement activities within and across markets.

In many respects, the provisions of this bill are an outgrowth of the October 1987 and, to a lesser extent, the October 1989 breaks in stock market prices. Whether in the context of this bill, or the ongoing work of the inter-agency group formed after the '87 stock market fall, or the initiatives of the various stock and futures exchanges, or the recommendations of the Group of Thirty regarding improvements in delivery and settlement systems for equities, or the efforts of individual firms to strengthen controls and procedures, much has been done to protect the system against the systemic disruptions that seemed so close at hand in 1987. But, I have to wonder aloud whether we will have gone far enough even if something along the lines of S-648 were promptly enacted.

For example, there are several areas in which I believe further steps should at least be considered. None of these is going to be very popular, but let me spell them out, if nothing else, as grist for the mill.

> First, while it is true that the bill is designed to authorize the S.E.C. to gather certain data on the overall financial condition of securities companies -- including information at the level of the holding company -- I'm not persuaded that we should necessarily stop with information gathering. For example, as a long time advocate of some limited degree of consolidated supervision in banking, it seems to me that careful thought should be given to the suggestion that minimal capital standards and a limited degree of consolidated supervision should apply not

only to registered broker dealers, but to the securities firm as a whole, including its parent holding company. This may be particularly appropriate in view of the fact that many of the more risky activities of such firms take place either at the level of the holding company or in an unregulated subsidiary of the holding company. Similarly, the opportunities for and the possible risks of excessive double leveraging are no less in the case of securities holding companies than they are for bank holding companies. Finally, it is also true that a system that relies on at least a degree of consolidated supervision for securities firms would be much more in keeping with arrangements in other industrial countries. Of course, what underlies my view in this regard is that I remain strongly of the opinion that serious problems in any one part of a financial firm will, inevitably, impact the firm as a whole despite legal separations and regulatory firewalls.

Second, I am still not at all sure that margins for financial futures are as high as they should be, at least from the vantage point of their role as a financial shock absorber helping to ensure the safety and integrity of the clearing and settlement mechanisms for such markets. My concern in that regard was heightened by events after the market sell-off on Friday, October 13, 1989. The C.M.E. increased margins on the S & P 500 contract by $1000 per contract for both the opening of business on Monday, October 16 and again on Tuesday, October 17.

While such actions can be highly appropriate in particular circumstances -- especially when motivated by the desire to protect the financial integrity of the clearing apparatus -- it is also true that increasing margins in circumstances such as those prevailing at that time can create the very problem that such actions are seeking to avoid. In fact, a good case can be made that margins should be high enough in the first instance that they don't need to be raised in emergency situations. Indeed, to take it one step further, the mere fact that margins must be raised in an emergency suggests that they may have failed to perform their functions.

Partly for this reason, and this is very much a personal view, I believe that margins in many financial-type futures instruments are typically -- if not systematically -- too low. In the case of the S & P 500 contract, for example, it seems to me that a significantly higher margin -- perhaps as high as 15 percent or so -- is always called for. I also have serious doubts as to the wisdom of leaving the day-to-day establishment and administration of minimum margins to the exchanges. In saying this, I know there are many who would take serious objection to this suggestion, primarily on the grounds that such higher margins would increase transactions costs and reduce liquidity in these markets. There may or may not be something to that argument but even if it were valid, it seems to me that achieving a somewhat deeper financial cushion in the clearing and settlement mechanisms associated with these markets may be worth these costs, especially to the extent that there is a tendency for such liquidity to be illusory in times of stress.

The ability of all markets to function well under adverse circumstances is crucial to their long-run health and competitiveness _and_ their ability to fulfill their fundamental role of helping to achieve the best possible allocation of savings and investment in the economy as a whole. It is in that spirit that I firmly believe that further debate and dialogue on this very controversial subject is urgently needed. The goal must be to find the proper balance between transactions costs and liquidity on the one hand and prudential standards on the other. This, of course, is a matter of judgment, but in my judgment the tilt should be in the direction of greater weight on the prudential considerations.

The third area I want to cite in this regard relates to clearance and settlement procedures and systems more generally. Here, great strides have been and are being made, as reflected in the effort to significantly accelerate final delivery and settlement of stock trades in the cash market. Under the best of conditions, however, that effort will take several years to complete. And, as revolutionary as these changes may seem to be, even so they do not come to grips with all the issues, especially the delicate relationship between clearance and settlement systems in the cash markets on the one hand and the derivative markets on the other. A goal worth striving for would be one in which the timing of final settlement in cash and derivative markets would be the same, since in these circumstances a strong case could be made that both the level and structure of margins in both markets could converge to a very significant extent. That may be a long way off since it presupposes, among other things, a comprehensive book entry system for equities. It also implies that we make further progress in satisfying market participants that overall market infrastructure -- including the all important credit decision-making apparatus -- is fully geared to shortened time frames for final payments and settlement. Finally, it implies that much of the burden for adjustment falls in the cash market, but I believe it is a goal worth striving for over time.

This also is an area in which the need to keep in mind the international attractiveness of U.S. markets and market related institutions is very important. That is, as technology changes and as other countries and other financial centers improve the workings of their financial markets, the relative position of U.S. markets can deteriorate unless we are making comparable or greater strides in improving the efficiency, effectiveness and stability of markets here in New York and in the U.S. generally. The United States has an important comparative advantage over most other countries in this regard and that is something worth preserving, consistent, of course, with the prior dictates of safety and stability.

The _last_ subject I want to touch on in this regard is circuit breakers, which I regard as something of a necessary evil. They are necessary because patterns of extreme market volatility seem to provide little alternative but to allow intervals of time during which market participants can better absorb information and react in an appropriate fashion. However, across the board halts in trading, and especially the closing of markets, can entail the risk of making things worse rather than better. At the very least, we must keep in mind that once a market is closed, it must be reopened -- a task that may not be easy.

Having said that, I must reluctantly confess that I believe we probably do need a system of circuit breakers. However, I also believe it very important that such circuit breakers must be closely and carefully coordinated between cash and derivative markets. For example, generalized trading halts and/or market closures should always be triggered in a context in which it is recognized that cash and derivative markets are, in fact, one. At the end of the day, however, our goal should be to encourage patterns of behavior in markets in which circuit breakers, even though they exist, never have to be used.

In a very real way, I find it regrettable that my sense of uneasiness about patterns of behavior in financial markets brings me to the point where I feel the need to put these ideas on the table for consideration. I say that for two reasons: first, whatever else may be said about these suggestions, it must be admitted that they deal with symptoms, not causes. The causes lie with the fundamentals: economic policies and performance, financial market structure, and the perverse incentives -- for business corporations, institutional and individual investors -- that produce such enormous preoccupations with the very short run; second, and not unrelated, all of us would be much more comfortable with an approach in which the marketplace itself was free to both reward and punish without reliance on regulatory or legislative safeguards. That, of course, raises the profoundly important question as to why such safeguards exist in the first instance.

The historic rationale for these safeguards has a number of foundations many of which are, one way or another, tied up in the understandable desire to protect small and unsophisticated investors and depositors. Even more essential, however, is the age old concern about systemic risk or the danger that a disruption in one part of the banking and financial system will spread to other parts of the system, thereby undermining confidence generally and inflicting damage on the real economy. As I have mentioned on a number of occasions, concerns about systemic risk are neither new nor are they unique to the United States. For example, in the Wealth of Nations, Adam Smith presents the classic case for the regulation of banking on precisely the grounds of systemic risk. Similarly, in every nation, regardless of size, state of development, or political persuasion, governments and monetary authorities are universally reluctant to tolerate the sudden and disorderly failures of banking and financial firms because of concerns about systemic risk and public confidence.

Looked at in that light, it is not surprising that governments of all types have chosen to have so-called "safety net" features associated with the workings of banking and financial system. While the particulars of such arrangements differ from country to country they are all deeply rooted in concerns about systemic risks and they all give rise, to some degree, to the so-called "moral hazard" problem.

In its most straightforward form, the moral hazard problem has as many as three dimensions. The first is that the mere presence of the safety net (regardless of its specific form) will encourage banking and financial firms to take on more risk than they otherwise would or could. The second is that depositors and/or other creditors will not subject such firms to the same tests of creditworthiness that they would for firms that are outside the safety net. The third is that the mere presence of concerns about systemic risk will force the central bank or other authorities to, in some fashion, intercede on behalf of troubled institutions by providing some form of financial or other support in the face of adversity, thereby validating the behavior implicit in the first two factors cited above.

As we have seen in the thrift industry situation, the moral hazard problem can be quite real and can give rise to sizeable claims on the public pocketbook. However, as reprehensible as the thrift industry situation may be, I believe it important that it not cloud our vision as to what makes for good public policy. In this regard, I believe the basic approach to the safety net in this country is workable and sound and while the point can be debated, I also believe that arrangements in the United States provide at least as much -- if not a greater -- role for market discipline than is the case in many other countries.

Having said that, allow me to quickly add that there are constructive changes in emphasis which could tilt things in the direction of greater market discipline and less implicit reliance on the safety net. I have in mind such possibilities as finding ways to deal with the abuses of brokered deposits, the swifter and earlier resolution of capital deficient -- though still technically solvent -- institutions, and achieving still higher levels of capital, especially equity-type capital and/or wholly unencumbered subordinated debt capital in financial institutions.

On the other hand, I find very troubling certain proposals which, on the surface, seem to have great intuitive appeal. For example, I am unconvinced as to the merits of extending deposit insurance premiums to offshore deposits in branches of U.S. banks, not simply on competitive grounds but far more importantly on the grounds that this would extend the appearance of full insurance to the one class of depositor that has unambiguously exerted a clear pattern of market discipline on large banks that get into trouble. While on the subject of large banks, let me say that I am mindful of the widespread view that some banks are too big to fail. That view has very troubling implications and does not jibe with reality. After all, a number of large banks have failed and in the process managers and shareholders have been wiped out. In other cases, market and regulatory pressures have forced troubled large institutions into major restructurings, shrinkages and the need to raise large amounts of new equity type capital despite the sizeable dilution of existing shareholders. Having said that, care and discretion will always be needed in handling serious problems in major institutions in order to guard against the systemic dangers I spoke of earlier.

With any troubled financial institution, but especially in the case of large institutions, I believe the workings of both the safety net and market discipline will be better served in a context in which the authorities maintain a policy of what I like to call "constructive ambiguity" as to what they will do, how they will do it and when they will do it. In saying this, I recognize that financial market participants don't like uncertainty, but that's just the point!! Moreover, while I fully understand the yearning in some quarters for something of a cookbook approach to problems in financial markets or institutions -- large institutions especially -- I regret to say that in my judgment such a cookbook does not and never will exist. The circumstances associated with a particular case, the setting in which it occurs and the assessment of the relative costs and benefits of alternative courses of action will always have to be looked at case by case. But in no case should it be prudent for market participants to take for granted what actions the authorities might take and certainly in no case should owners and managers of troubled institutions -- large or small -- conclude that they will be protected from loss or failure.

I began these remarks with a series of references to all of the difficulties and disruptions our financial system and economy surmounted during the 1980s. We can and should take a measure of satisfaction from that experience but we must attend to the potential sources of problems down the road. While many of the solutions to those problems lie with the economic policy fundamentals, steps that would improve the structure and workings of our financial system are an important part of that agenda for the future. The case for such improvements seems to me clear on its own merits but we should also keep in mind that the international competitiveness of our financial markets and institutions is very much at stake.

Looked at in that light, there are many factors that will, over time, be important in maintaining a competitive edge in banking and financial services. However, one overriding consideration will surely be public confidence -- both here and abroad -- in such markets and institutions. In turn, that confidence will flourish only in a setting in which our major institutions are not just strong and sound, but the strongest and soundest and in a setting in which the safety and absolute integrity of such markets and institutions are beyond question. You can judge for yourselves where we stand on that spectrum but I for one, think we have some work to do.

Thank you.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM RICHARD C. BREEDEN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

December 20, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
Washington, D.C. 20510-6075

Dear Chairman Riegle:

Attached are the answers to the questions posed by Senator Sasser concerning proposals regarding the regulatory structure of the stock index futures market.

Sincerely,

Richard C. Breeden
Chairman

Q. 1. Volatility in the securities markets and the flight of the small investor are problems we all want to address. With fewer individuals owning stock, we have fewer long-term owners. And a lack of long-term ownership makes our corporations very short-sighted.

There are any number of causes of this volatility. It may be that trading in stock index futures is a leading cause. However, it may be simpler than that. It may be that we have volatility because much more stock is owned by institutions. And these institutions tend to turn over their ownership faster.

Senator Sanford and I have introduced a bill called the "Long-Term Investment, Competitiveness and Corporate Takeover Reform Act of 1990." The bill contains an anti-churning rule called the "short-short" test. Under the short-short test, mutual funds are prohibited from earning more than 30 percent of their income from stocks held less than three months. Our bill would extend this rule to pension funds; the logic being that all the big players would be under the same rules.

Our provision amends ERISA, it is not a tax. What do you think of this approach to the volatility and short-term outlook question?

A. 1. Long-term investment is vitally important to our capital markets and to our economy. Long-term capital formation should be strongly encouraged, with greater national emphasis on all forms of savings. While most specific proposals for legislative and regulatory change in this area are outside the Commission's direct area of responsibility, legislative or regulatory steps that would create incentives for long-term investment perspectives, while not imposing undue costs, would be desirable.

There are many legitimate short-term trading strategies engaged in by a number of institutional investors. The portfolio turnover rate of institutional investors is one of many factors influencing market volatility, but it is not the predominant cause of the periodic spikes of extraordinary volatility in our nation's securities markets. Rather, the episodes of the most extreme price movements in the securities markets are exacerbated by the extraordinarily low margin levels in the stock index futures markets. These low margin levels encourage speculative trading, which creates the illusion of deep liquidity. When prices start to move rapidly, however, that liquidity disappears, causing price declines to accelerate. Indeed, the market breaks of October 1987 and 1989 each came at a time when stock index futures margins were at or near historic lows, with maximum leverage as high as nearly 98%. Therefore, I have supported prompt passage of S.2814, proposed by the Administration, which would establish a comprehensive scheme of federal regulation for stock index futures margins.

Restrictions on trading strategies and techniques of market participants could do significant damage to our markets. The basic conditions for trading, such as allowable leverage and clearance and settlement systems, not trading strategies, should be the focus of governmental efforts.

Q. 2. I keep hearing that most of the world's developed trading markets have one regulator of stocks and futures.

a.) But is there a very developed futures market anywhere else, so is this even a relevant point?

A. 2a. Yes, there are developed stock index futures markets in Japan, France, the United Kingdom and other countries. Growth rates in several of these markets in recent years have been very strong, while volume in U.S. stock index futures markets was declining substantially. In all of these markets, there is a single governmental authority which has ultimate oversight responsibility for both the stock market and the stock index futures market. For example, in Japan the Securities Bureau of the Ministry of Finance has authority over stocks and stock index futures. Both the Tokyo and Osaka Stock Exchanges have a thriving stock index futures market, with volume almost equal to that of U.S. markets. Similarly, in the United Kingdom, Canada, France, and Australia, there are vibrant stock index futures markets, albeit with smaller volume than in the U.S. or Japan. In these countries, there is one authority with the ultimate regulatory responsibility for trading in stocks and stock index futures. Indeed, in the United Kingdom, we understand that the self-regulatory organizations with responsibility over the stock and stock index futures markets, The Securities Association and the Association of Futures Brokers and Dealers, respectively, are planning to merge in order to rationalize their operations.

b.) Does the fact that we have two regulators cause real problems in terms of cooperation with other regulators?

A. 2b. Yes. The fragmentation of regulatory jurisdiction can impede the Commission's efforts to respond to the globalization of the world's securities markets. As a result of our bifurcated regulatory system for stocks and stock index futures, neither the SEC nor the CFTC can negotiate comprehensive agreements concerning the equity and equity derivative markets with our regulatory counterparts from other countries. Instead, international negotiations must be conducted in separate stages, a process that makes it less likely that over time the United States will achieve the best possible agreements for its markets as a whole. Moreover, the ability of each agency to speak authoritatively and to represent the interests of the U.S. financial markets in international discussions is adversely impacted by its limited jurisdiction. In addition, intermarket surveillance is impeded, because many intermarket fraud investigations with international dimensions require coordination and cooperation between securities and futures regulators. This cumbersome process does not represent a sensible allocation of resources, and it reduces the ability of the U.S. negotiators to maximize overall U.S. interests in designing global regulatory principles.

Q. 3. Is there a practical difference between margins on stock and futures? If there is, why does it matter if they're set at different levels?

A. 3. Although it is often argued that futures margin serves as a performance bond and that securities margin serves as an extension of credit, this is inaccurate, and it misses the main point. First, as a technical matter, margins on options and short stock positions serve the same function as futures margin. Moreover, both securities and futures margins control the effective economic leverage available in a financial instrument. Unlike stock margin, though, the margins on stock index futures are not subject to federal oversight. Instead, stock index futures margins have been set by the futures exchanges without any public oversight to determine whether the public's interests in safe and stable markets is being adequately served.

At critical times, including the market breaks in 1987 and 1989, margins in the stock index futures market were set close to zero. In both these situations, margins that were too low for safety were raised sharply during the crisis, thereby draining massive liquidity out of the market when it was under the greatest pressure. This created a serious risk that market participants might have to dump contracts on the market in order to meet margin calls, thereby accelerating the market's decline. Treasury Secretary Brady and others have observed that the need to raise low stock index futures margins sharply during a market disturbance could be the catalyst that turns a temporary drop in the stock market into a free-fall in all equity products that could inflict significant damage on the securities markets and the overall U.S. economy.

Thus, it is not the fact of differences in margin levels that is the problem. Stock index futures margins should not be set at the same level as stock margins for several legitimate technical reasons. However, allowing a major financial market to be operated, even at times, on nearly 100% leverage could prove disastrously risky. The current system in which only the traders who profit from volume set the leverage limits is not adequate to protect tens of millions of market participants.

Q. 4. One of the findings of the Brady Commission was that speculation in corporate takeover stocks had fed the run up in the stock market prior to the crash of October 1987. I also understand that the collapse of negotiations for the buyout of United Airlines contributed to the 200 point one day drop in October.

What role does speculation by large traders in corporate takeovers and leveraged buyouts play in causing volatility in the market?

A. 4. Speculation by large traders in corporate takeovers and leveraged buyouts is not the foremost cause of volatility in the markets, although such activity can be a contributing factor. As a general matter, takeover speculation tends to center on particular stocks that are judged to be particularly attractive takeover candidates, and not on the market as a whole. Trading in stock index futures, on the other hand, can have a broader impact on the stock market, because the stock index futures market serves as a proxy for investment in the entire stock market. In addition, as stock index futures prices change, that change is transmitted back into the price of each component stock of the stock index through index arbitrage.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SANFORD FROM RICHARD C. BREEDEN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE CHAIRMAN

December 20, 1990

The Honorable Donald W. Riegle, Jr.
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Dear Chairman Riegle:

Attached are the answers to the questions posed by Senator Sanford concerning proposals regarding the regulatory structure of the stock index futures market.

Sincerely,

Richard C Breeden

Richard C. Breeden
Chairman

Terry Sanford

QUESTIONS FOR THE PANEL REGARDING SEC/CFTC JURISDICTION
MARCH 29, 1990

SENATOR TERRY SANFORD

Q. 1. **For Mr. Glauber:** You note in your testimony that the broadest solution would be to merge the SEC and the CFTC. While you state that a merger is the broadest solution, does the Treasury believe it is the best solution?

Q. 2. **For Commissioner Gramm:** The argument that changes in or increases in our margin requirements could force futures trading overseas presupposes, to some extent, that margins in overseas markets are currently the same as or less than U.S. margins. Is this the case? What are the margins on futures in overseas markets and how do they relate to the U.S. margins?

Q. 3. One of the issues that is often raised in looking at the problem before us today is that of volatility in the market. While each of you has touched on the issue of volatility and given various explanations for some of the current volatility, I am afraid that a good deal of it comes down to a shift in the market away from individual investors in single equities to institutional investors, some of which have very high turnovers in their portfolios.

Indeed, a recent study noted that the 13 largest pension funds on average turned over in excess of 60 percent of their portfolio assets every year and that 20 of the largest institutional investors turned over their entire portfolio each year. Studies by the Department of Labor indicate that pension fund returns are reduced as a result of transaction costs associated with high turnover rates.

In response to this problem, our colleague Senator Kassebaum introduced a bill to tax short-term gains by pension funds. Senator Sasser and I proposed an alternative approach--applying the "short-short" rule that applies now to mutual funds to pension funds as well. This rule provides that funds cannot make more than 30% of their profit from stocks held for more than 3 months.

Could you comment on this issue. Are these turnover rates troubling? Are they adding volatility to the markets? Do you have any particular approach to address the problem? Would you favor the application of the "short-short" rule to pension funds?

A. 3. Long-term investment is vitally important to our capital markets and to our economy. Long-term capital formation should be strongly encouraged, with greater national emphasis on all forms of savings. While most specific proposals for legislative and regulatory change in this area are outside the Commission's direct area of responsibility, legislative or regulatory steps that would create incentives for long-term investment perspectives, while not imposing undue costs, would be desirable.

There are many legitimate short-term trading strategies engaged in by a number of institutional investors. The portfolio turnover rate of institutional investors is one of many factors influencing market volatility, but it is not the predominant cause of the periodic spikes of extraordinary volatility in our nation's securities markets. Rather, the episodes of the most extreme price movements in the securities markets are exacerbated by the extraordinarily low margin levels in the stock index futures markets. These low margin levels encourage speculative trading, which creates the illusion of deep liquidity. When prices start to move rapidly, however, that liquidity disappears, causing price declines to accelerate. Indeed, the market breaks of October 1987 and 1989 each came at a time when stock index futures margins were at or near historic lows, with maximum leverage as high as nearly 98%. Therefore, I have supported prompt passage of S.2814, proposed by the Administration, which would establish a comprehensive scheme of federal regulation for stock index futures margins.

Restrictions on trading strategies and techniques of market participants could do significant damage to our markets. The basic *conditions* for trading, such as allowable leverage and clearance and settlement systems, not trading strategies, should be the focus of governmental efforts.

Q. 4. Other suggestions have been made that short-selling may be part of the problem as well. Hearings were held on the House side to create a reverse 13(d) which would require short sellers with a short position exceeding 5 percent of a company's outstanding shares to file a public report with the SEC of their position.

What do you think of that proposal? Is short selling part of the problem?

A. 4. The Association of Publicly Traded Companies has petitioned the Commission to adopt a rule imposing a disclosure requirement on short sellers of five percent or more of an issuer's outstanding shares. I expect the Commission to consider this petition at a public meeting early in 1991.

Nevertheless, I do not believe that short selling in the stock market is the cause of the recent periods of unusual volatility in the securities markets. As you know, investors in the stock market may not sell stock short except on an "uptick" (when the sale price is higher than either the last recorded sale price or the last recorded sale price that is different from the current sale price). The stock index futures markets are not subject to a comparable restriction, and indeed such a restriction would be impractical in the context of derivative markets. Therefore, investors in the stock index futures market can sell short at any time, thereby creating downward pressure, when stock index futures prices are falling, that is transmitted back to the stock market through the mechanism of index arbitrage, generally by means of long sales. A disclosure requirement would not affect this type of index arbitrage.